



**EXPLODING DEFICITS, DECLINING GROWTH:
THE FEDERAL BUDGET AND
THE AGING OF AMERICA**

**A Policy Statement by the Research and
Policy Committee of the Committee for
Economic Development**

March 2003

*CED is a nonprofit, nonpartisan
organization of business leaders
and educators that has worked
for sixty years to address the
critical economic and social
issues facing American society.*

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CONTENTS

RESPONSIBILITY FOR CED STATEMENTS ON NATIONAL POLICY	iv
PURPOSE OF THIS STATEMENT	vii
SUMMARY, FINDINGS, AND RECOMMENDATIONS	1
Summary	1
Substantive Findings	1
Recommendations	2
Principles for Budget Policy	2
Policy Recommendations	2
CHAPTER 1: AN OVERVIEW OF THE FISCAL PROBLEM	4
Do Deficits Matter?	5
CHAPTER 2: THE BUDGET OUTLOOK FOR THE NEXT DECADE	10
The Disappearing Surpluses	10
Deficits "As Far As the Eye Can See"	13
CHAPTER 3: THE IMPENDING THREAT TO AMERICA'S LIVING STANDARDS	17
America's Changing Age Distribution	17
The Pressures to Reduce National Saving: The Economics of an Aging Population	18
A Vicious Circle of Slower Growth	22
CHAPTER 4: BUDGET POLICIES FOR GROWTH	25
Unpalatable Choices	25
Can We "Grow Our Way Out" of the Long-Term Deficits?	26
What Gives? Principles for Fiscal Policy Choices	26
Coordinating Long- and Short-Term Policies: Do We Need More Fiscal Stimulus?	28
Recommended Directions for Policy	29
Provide a Framework for Long-Term Budgetary Decision-Making	29
Reform Major Entitlement Programs	31
National and Homeland Security Expenditures	35
Non-Security Discretionary Spending	36
Taxes	37
Conclusion	38
MEMORANDA OF COMMENT, RESERVATION, OR DISSENT	40
OBJECTIVES OF THE COMMITTEE FOR ECONOMIC DEVELOPMENT	42

RESPONSIBILITY FOR CED STATEMENTS ON NATIONAL POLICY

The Committee for Economic Development is an independent research and policy organization of some 250 business leaders and educators. CED is non-profit, non-partisan, and non-political. Its purpose is to propose policies that bring about steady economic growth at high employment and reasonably stable prices, increased productivity and living standards, greater and more equal opportunity for every citizen, and an improved quality of life for all.

All CED policy recommendations must have the approval of trustees on the Research and Policy Committee. This committee is directed under the bylaws, which emphasize that “all research is to be thoroughly objective in character, and the approach in each instance is to be from the standpoint of the general welfare and not from that of any special political or economic group.” The committee is aided by a Research Advisory Board of leading social scientists and by a small permanent professional staff.

The Research and Policy Committee does not attempt to pass judgment on any pending specif-

ic legislative proposals; its purpose is to urge careful consideration of the objectives set forth in this statement and of the best means of accomplishing those objectives.

Each statement is preceded by extensive discussions, meetings, and exchange of memoranda. The research is undertaken by a subcommittee, assisted by advisors chosen for their competence in the field under study.

The full Research and Policy Committee participates in the drafting of recommendations. Likewise, the trustees on the drafting subcommittee vote to approve or disapprove a policy statement, and they share with the Research and Policy Committee the privilege of submitting individual comments for publication.

The recommendations presented herein are those of the trustee members of the Research and Policy Committee and the responsible subcommittee. They are not necessarily endorsed by other trustees or by non-trustee subcommittee members, advisors, contributors, staff members, or others associated with CED.

This policy statement was completed before the release of the Congressional Budget Office's (CBO) Interim Report, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2004* on March 7, 2003. The fundamental analysis and conclusions of this policy statement are not changed by the data and estimates in that report. However, CBO's ten-year baseline deficit projections have deteriorated somewhat in comparison with those it made in January, principally as a result of the Omnibus Appropriations Act of 2003. Using the new CBO estimates, CED's projections of a more realistic budget outlook for the next decade would be even more unfavorable than those shown in Chapter 2. The projected 2004-2013 deficit would be roughly \$2.5-3.0 trillion, with annual deficits early in the next decade on the order of \$350-450 billion. Were all the President's new proposals to be enacted, the projections would show those annual deficits to be roughly \$600-700 billion and the 2004-2013 deficit to be \$4.0-5.0 trillion.

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* Voted to disapprove of this Policy Statement.

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PURPOSE OF THIS STATEMENT

Since 1947, the Committee for Economic Development (CED) has championed federal fiscal discipline to sustain America's long-term economic health. CED first did so in the seminal statement *Taxes and the Budget: A Program for Prosperity in a Free Economy* (1947) and more recently in *Restoring Prosperity: Budget Choices for Economic Growth* (1992). Federal budget deficits raise interest rates, reduce domestic investment, and increase America's foreign indebtedness. Today, this reality is as relevant and important as it was six decades ago. In this statement, CED explains why America's federal fiscal policy is pointed in the wrong direction and how to change course to better protect economic growth and the living standards of future generations.

The federal government brought its borrowing under control in the mid-1990's. But, in recent years, this discipline has dissolved. The Congressional Budget Office's projected ten-year budget surplus for this decade has gone from \$5.61 trillion to nearly zero. Only part of this deterioration can be attributed to a weak economy and a lower stock market; the majority of the collapse can be directly linked to policy decisions. Adjusting the projections to reflect more realistic assumptions, and the economic effects of the aging of the baby boom generation, deficits now extend "as far as the eye can see."

Absent significant changes to current policy, America will be ill-prepared for this imminent demographic transition. If policymakers do not begin making hard decisions today that restore fiscal balance, America will face an even larger and more painful retrenchment in the future.

This statement concludes with a series of

principles and recommendations that address both budget process and policy. We recognize that our proposed program is ambitious, but we believe that bold reforms are necessary to close the long-run fiscal gap and to insure that the American dream lives on, with future generations continuing to enjoy better living standards than those before them.

ACKNOWLEDGMENTS

This policy statement was developed by the committed and knowledgeable group of business, academic, and policy leaders listed on page vi. We are grateful for the time, efforts, and care they put into this effort.

Special thanks go to the subcommittee chair, W. Bowman Cutter, Managing Director of Warburg Pincus LLC. We are also indebted to Van Doorn Ooms, CED Senior Fellow and director of this project. CED Research Associate David Kamin also made substantial contributions. Therese Scharlemann and Rebecca Solow provided research assistance.

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Summary, Findings, and Recommendations

SUMMARY*

CED believes that the official budget projections by the Administration and the Congressional Budget Office (CBO) significantly understate the nation's fiscal problem. In the short term, they do not allow for pending actions (such as making tax cuts permanent, providing prescription drugs to seniors, and possible war and reconstruction in Iraq) that will exacerbate the deficit. In the longer run, they do not account for the aging of the population, which will put both a drag on economic growth and massive demands on the federal budget. This makes it essential to conserve fiscal resources now to grow the economy for the future.

Deficits matter – they lead to less investment, less productivity, and a lower future standard of living. They are large and about to become very large. Were we to put the budget on a sound actuarial footing through 2075 – the lifetime of a child born today – we would have to close a gap of almost *5 percent of gross domestic product – equivalent to current spending cuts or tax increases of roughly \$500 billion per year*. Any deficit reduction program to significantly reduce a gap of this size will necessarily require a “war on many fronts” – reshaping Social Security, reforming Medicare and Medicaid, rationalizing defense and homeland security spending, as well as raising additional and alternative tax revenues. For this reason, we should reject any short-term stimulus that adds to future deficits and slows growth later. None of these actions are pleasant. But all of them must be taken to secure our nation's economic future.

*See memoranda by JAMES Q. RIORDAN and THOMAS J. BUCKHOLTZ (page 40).

SUBSTANTIVE FINDINGS

Current budget projections seriously understate the problem. In 2001, CBO foresaw a cumulative budget surplus of \$5.6 trillion for the ten years 2002-2011; two years later, that \$5.6 trillion is effectively zero. And this new projection does not take into account the strong likelihood that the 2001 tax cuts will be made permanent, that the rapidly expanding Alternative Minimum Tax will be scaled back, or that war and reconstruction in Iraq will raise discretionary spending. Adjustments for such likely events imply a ten-year deficit of about \$2 trillion, *before* any new tax proposals are enacted or the costs of a possible prescription drug program, among other outcomes, are added. (See pp. 13-16)

While slower economic growth has caused much of the immediate deterioration in the deficit, the deficits in later years reflect our tax and spending choices. By the end of the decade, after the economy has fully recovered, budget policies are projected to account for two-thirds of the increase in the deficit. (See pp. 10-13)

Deficits do matter. To the extent deficits are paid out of domestic saving, they leave less money behind to finance investments in plant and equipment, research and technology, and human capital that make us more productive. To the extent they are financed by foreigners, they increase our nation's international debts, divert our future income to service those debts, and increase economic instability. In either event, deficits will reduce our future standard of living. (See pp. 5-9)

The aging of our population compounds the problem. The onset of baby boom retirements in the next decade and the nation's low fertility rate will gradually produce an economy with many more retirees and proportionately far fewer workers, even after accounting for immigration. This

means that future Americans will divide a slower-growing “income pie” into smaller pieces. But future consumption needs will not decline; in fact, the demands of an aging population for health services, including those financed publicly, will skyrocket. This suggests that America will save even less, and therefore have fewer resources available to invest for growth. Later in this century, for the first time, Americans may be less well off than their predecessors. (See pp. 17-24)

RECOMMENDATIONS

Principles for Budget Policy (See pp. 26-28)

First, *any tenable budget program must address the budget deficit on every front, including both comprehensive spending reductions and alternative or additional revenues.* The budget choices we face all appear to be untenable: cutting Social Security and Medicare; constraining defense spending; raising taxes. But that is exactly the point. None of these measures alone will suffice; all must be brought to the table to construct a workable solution. While reshaping Social Security or Medicare or raising additional taxes is unattractive, the real choice is between planned and rational policies now, or more chaotic and severe steps down the road.

Second, *do no harm.* The first step in climbing out of a hole is to stop digging. We cannot afford economic policy decisions today that further raise deficits tomorrow. Recent and pending tax and spending proposals by the Administration and decisions by the Congress should be considered and reexamined in this longer term context.

Third, *make long-term budgetary balance and economic growth explicit policy goals.* Without long-term fiscal policy goals, our budget policy is adrift without an anchor. Without an anchor, policy will be driven by the political winds. It is essential that current decisions be taken with full recognition of the harmful consequences that loom ahead on our current budgetary course. We are concerned that the Administration’s 2004 budget would raise the ten-year 2004-2013 deficit by about \$2.7 trillion and annual deficits

ten years from now by about \$500 billion.

Fourth, *give pro-growth policies higher priority.* We must avoid budget cuts that reduce public investments in favor of today’s consumption. As the budget deficit grows, a disproportionate burden of fiscal restraint may fall on education and training programs that build human capital, research and development activities that advance knowledge, and infrastructure investments that support the private sector. In previous reports, CED has noted the importance of such public investments for economic growth.

Fifth, *distribute the costs of pro-growth policies equitably.* Who should bear these costs? Programs with widely shared benefits are preferable to those with benefits tailored narrowly to few recipients. In addition, the burden of fiscal restraint should not be placed disproportionately on low-income families with little political voice. As former OMB Director David Stockman said, in a different era but a similar context, we should resist weak claims, not weak claimants.

Policy Recommendations

1. **CED strongly opposes any short-term stimulus program that is not combined with a plan to restore longer-term budget balance.** We are specifically concerned that the Jobs and Growth Package proposed by the Administration, which would raise the cumulative 2004-2013 deficit by about \$920 billion (including interest) and raise the annual deficit ten years from now by about \$100 billion, does not meet this test. (See pp. 28-29)
2. **CED believes it is urgent to implement a disciplined budget process that can address the long-term fiscal issues that face us.** First, Congress must restore rationality to the appropriations process. Second, we should implement annual joint budget resolutions, agreed to by Congress and the President and enacted into law, that anticipate, precede, and control all spending and tax legislation. To enforce the budget decisions of the joint resolution, we should restore the caps on discretionary spending and the

requirement that changes in tax and entitlement programs be “deficit-neutral.” Finally, we also oppose the use of “dynamic scoring” in making Congress’s official budgetary cost estimates. (See pp. 29-31)

3. **CED calls on the President and Congress to establish a goal of balancing the budget (or producing a surplus) excluding the “off-budget” Social Security accounts over a rolling five-year horizon.** The joint budget resolution should make clear how the budget policies of the resolution would promote this goal. The joint budget resolution should also provide statistical measures of *long-term* fiscal balance (such as the “fiscal gap” and unfunded government liabilities). (See p. 30)
4. **CED reiterates its proposal to restructure Social Security into a two-tier system.** The current basic system would have its benefit structure modified to ensure its solvency (for example, by gradually raising the age for full retirement benefits to 70 by 2030) and would be supplemented by a second tier of privately owned Personal Retirement Accounts funded by mandatory employer and employee contributions that would raise returns to future retirees. (See p. 32)
5. **CED reiterates its earlier recommendation that the federal government restructure the Medicare program along the lines of the Federal Employee Health Benefit Program (FEHBP).** We also urge the states to adopt health care programs similar to FEHBP for public employees and Medicaid, with contribution structures that encourage choices based on appraisals of quality and cost. (See p. 34)
6. **CED believes that, whatever the level of spending, the defense and security budgets must be cost-effective and focused sharply on our new national security situation.** We urge the Administration and the Congress to rapidly establish national defense priorities and program reforms to accomplish this. The Tail-to-Tooth Commission, and others, have made recommendations for reducing overhead and indirect expenditures and other measures to reduce costs. In addition, we

urge the Administration and Congress to provide special attention and scrutiny to homeland security expenditures. (See pp. 35-36)

7. **CED recommends that we reduce the growth of non-security discretionary spending below its historical level and far below the 9 percent annual growth of the past three years.** Although the Administration sought to restrain such growth, the enacted omnibus 2003 appropriations bill has raised discretionary spending about \$12 billion above the level earlier agreed to by the President and the Congressional majority leadership. The recent untimely and chaotic appropriations process has dramatically demonstrated the need for the strong process reforms we propose. (See pp. 36-37)
8. **CED believes that education reform is too important to be allowed to fail; the federal government, which has mandated a national effort, is obligated to assist the states in making it work.** We urge the Administration and Congress to provide the funding needed to do so. (See p. 37)
9. **CED once again urges the Administration and Congress to make basic research a high priority in the federal budget.** Funding should be provided across a broad set of research fields, without undue concentration in medical research. (See p. 37)
10. After reviewing the size of our long-term fiscal imbalance and the broad possibilities for spending reductions in Social Security, Medicare, national and homeland defense, and other domestic programs, **CED believes it is extremely unlikely that the long-term budget problem can be solved without additional revenues.** We therefore urge the Administration and Congress to forego at this time any additional tax reductions (including the permanent extension of The Economic Growth and Tax Relief Reconciliation Act) that would further reduce long-term revenues. Moreover, we should use this opportunity to begin to explore alternative or additional long-term sources of revenue and taxation systems that support our nation’s growth objectives. (See pp. 37-38)

Chapter 1

An Overview of the Fiscal Problem

When the federal budget for fiscal year 2001 was first submitted to the Congress, the Congressional Budget Office (CBO) foresaw a cumulative budget surplus of \$5.6 trillion for the ten years, 2002-2011. Two years have now passed, and, according to the latest CBO projections, that projected \$5.6 trillion surplus is now effectively zero. Such a dramatic deterioration in the fiscal outlook is unprecedented.¹

Several years ago the federal budget appeared to be moving in a “virtuous circle,” in which surpluses helped finance capital formation and growth and reduced federal interest costs, both of which contributed to additional surpluses that would further raise economic growth. By the time the baby boomers moved into retirement and exercised their claims against the budget and, more importantly, against the nation’s future output and income, our productive capacity and budgetary position would have strengthened enough to withstand these new spending requirements. But a realistic projection of the budget today shows sustained deficits that will become far larger when the baby boom claimants retire. In short, the budget outlook has shifted dramatically for the worse, losing all the ground gained in the last decade.

This CED policy statement traces the relationships among federal budget deficits, the nation’s swiftly approaching demographic transition (a major influence on budgets in the longer term), and America’s economic future. The three are intertwined, but the focus here is on budget deficits, since they are (or should be) the factor under our immediate control. Specifically, we will address four important questions:

- First, *why do budget deficits matter?* Unless one understands why and how deficits have important economic consequences, one

cannot know why it’s so important to address them now.

- Second, *how did this fiscal reversal occur?* What were the relative contributions of changed economic conditions, spending decisions, tax decisions, and other factors to our fiscal predicament?
- Third, *what is a realistic budget outlook?* The official Administration and CBO budget projections do not portray the seriousness of the current situation. If we use reasonable assumptions about how the economy will perform, the choices politicians may make, and underlying trends in American society – particularly regarding the aging of the population – the budget outlook is alarming.
- Fourth and finally, *what can we do about it?* What major changes in the direction of long-term fiscal policy must we make to improve the prospects for long-term economic growth, and what are our options for making them?

The current chapter of this policy statement and the three that follow answer these questions. This chapter explains why fiscal deficits matter to the economy. The next chapter asks how the recent projections of sustained surpluses turned negative so quickly, and what a reasonable projection for the next five and ten years might now be. The third chapter looks beyond the five and ten year horizons used by federal budget planners, with an eye to the needs created in future decades by an aging population. And the last chapter examines various options for correcting the fiscal problems we face.

We wish to emphasize that this policy statement addresses our *long-term* fiscal predicament and its impact on the future well being of

Americans, *not* the issue of *short-term* fiscal stimulus as an antidote for current weakness in the economy. Our recommendations in Chapter 4 have strong implications for short-term policy, but our focus is on the long-term consequences of such policy. We strongly reaffirm our 2001 recommendation (made shortly after the September 11 terrorist attacks) that short-term policies must fit within a sound long-term framework. We urged then that any fiscal stimulus measures be timely, effectively targeted, and (especially) “temporary and combined with a credible commitment to future budget surpluses.”² If we do not do so, we will make the future problems we describe even more difficult to resolve.

DO DEFICITS MATTER?

Ever since federal deficits exploded in the 1980’s, economists have debated their short- and long-term effects. While there is no unanimity among economists, there are some important principles on which most economists, and CED, agree.

First, we know that the key to long-term economic growth and rising living standards is increasing productivity, our ability to produce more goods and services with the resources at our disposal. As a forthcoming CED report discusses in greater detail, we also know that long-term improvements in productivity come from three interrelated factors – technological progress (new ideas), investment (both in *physical* capital, which provides workers with more plant and equipment, while bringing new ideas into daily use, and *human* capital, which improves the skills and abilities of workers), and reorganization (the capacity to organize production to capture the benefits of this innovation).³ The economy grows, therefore, when new ideas are developed, when they are reflected in a more productive capital stock and labor force, and when the economy is flexible and adaptive enough to respond to new opportunities.

Second, we know that federal budget deficits interfere with this process primarily by siphoning off funds from private investment (and may

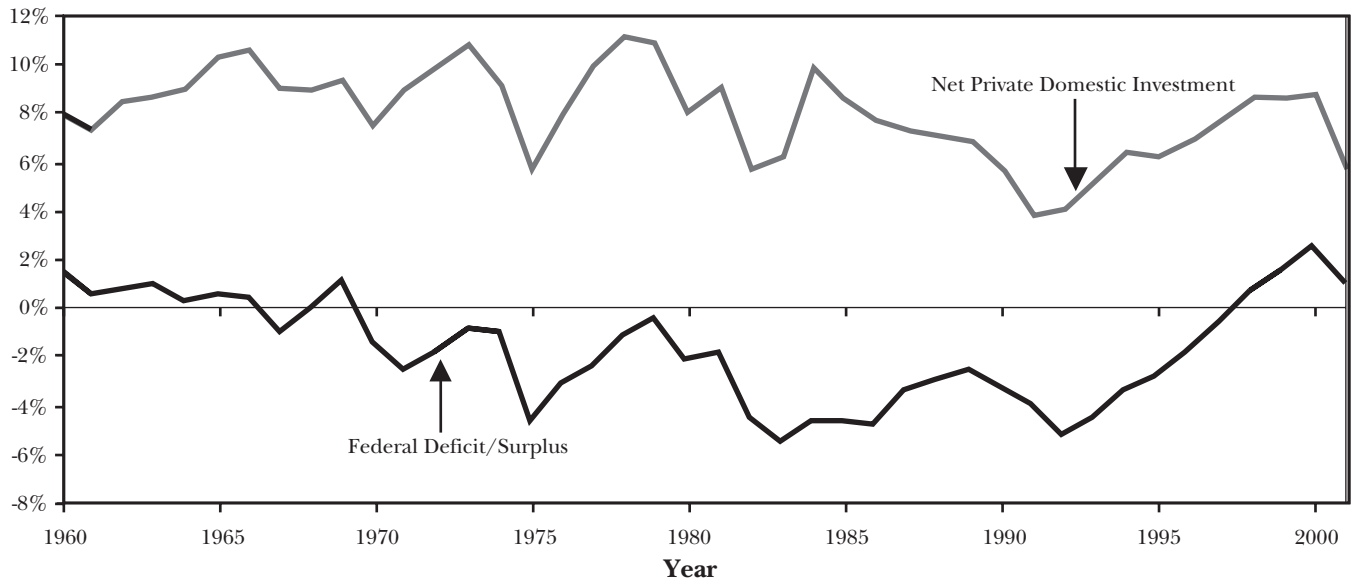
reduce public investment as well, as explained below). Deficits usurp the national saving otherwise available for investment. Saving diverts from current consumption the resources needed to finance plant and equipment, research, housing, or other investments. This saving takes the form of household saving, business profits, and government surpluses. Just as the nation’s saving is diminished when households borrow to spend more than their income, that saving is also diminished when the government spends more than its revenues. When the government borrows by selling government debt to finance the resulting deficit, it reduces the saving available for private investment at home or abroad.*

By reducing private investment at home, higher deficits leave the nation with a smaller capital stock, giving our workforce fewer tools with which to work – whether computers and software, machines, transportation equipment, or buildings and other structures. This slows the growth in the productivity of our workers, which, in turn, leads to slower growth in living standards. Deficits — and the higher mortgage rates that usually accompany them — can also reduce investment in housing, which also reduces future well being.

Thus, the central charge against fiscal deficits is that they “crowd out” private domestic investment by reducing national saving. The record of the past 40 years illustrates this relationship. Figure 1-1 shows federal deficits (or surpluses) and total net private domestic investment (including housing) for 1960-2001 in relation to net national product (NNP). Deficits and investment are inversely related – when

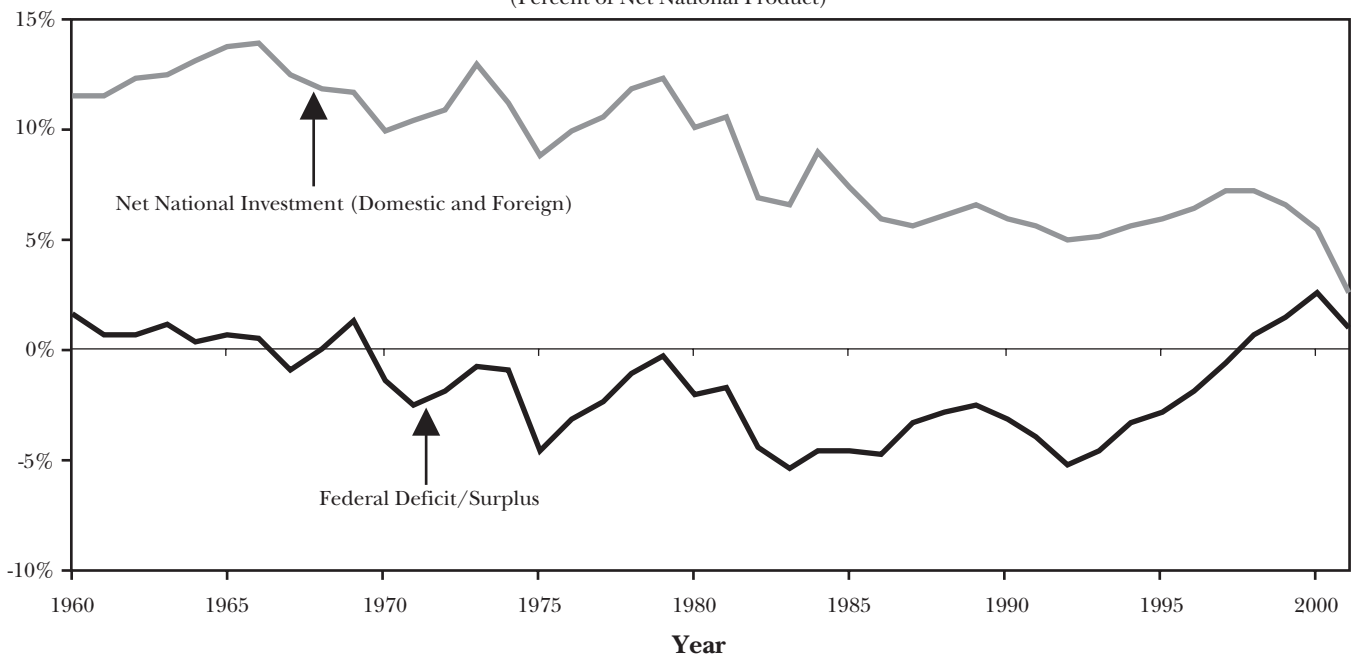
* While lower national saving must reduce national investment, not all economists agree that larger deficits reduce national saving. A minority argues that if deficits rise, households will increase their saving by a corresponding amount to provide for future tax increases, to be imposed on either them or their descendants. This is an interesting theory, but there is little empirical evidence that households make significant adjustments of this kind. The U.S. household saving rate has been falling more or less continuously since the early 1980s, during periods of both rising and falling deficits. Moreover, this view requires households to have extraordinary foresight; if government and private forecasters have been so continually surprised by rapidly changing deficit forecasts, how are we to assume that the average household can do better? See B. Douglas Bernheim, *Ricardian Equivalence: An Evaluation of Theory and Evidence*, Working Paper No. 2330 (Cambridge, MA: National Bureau of Economic Research, 1987).

FIGURE 1-1
Federal Deficits Crowd Out Private Investment
 (Percent of Net National Product)



Source: Updated from Benjamin Friedman, *What Have We Learned from the Reagan Deficits and Their Disappearance*, Working Paper No. 7646 (Cambridge, MA: National Bureau of Economic Research, 2000).

FIGURE 1-2
Less Government Saving Means Less National Investment
 (Percent of Net National Product)



Source: Bureau of Economic Analysis.

deficits rise, investment tends to fall; when deficits fall (or turn to surpluses), the additional saving tends to “crowd in” more private investment. Certainly, many other factors,

including changes in the strength of the economy and the international factors discussed below, have affected both deficits and domestic investment over this stretch of history. But the

“crowding out” of domestic investment by federal deficits is not just an abstraction suggested by economic analysis; it has been a historical fact, particularly during the large changes in the deficit during the 1980’s and 1990’s.

With regard to the effects of deficits on our foreign investment, the story is more complex. U.S. firms and investors that buy U.S. government debt can purchase fewer foreign assets, whether auto plants in Brazil or stocks issued by enterprises in emerging markets; similarly, foreign investors who buy such debt acquire a claim against the U.S. In both cases, the U.S. net international investment position deteriorates – we own fewer assets abroad, and foreigners own more of our assets. Thus, the nation’s wealth becomes smaller, and incomes of Americans in the future will be correspondingly reduced – either because the total income we earn on our foreign assets will be smaller, or because we must pay more income to foreigners.

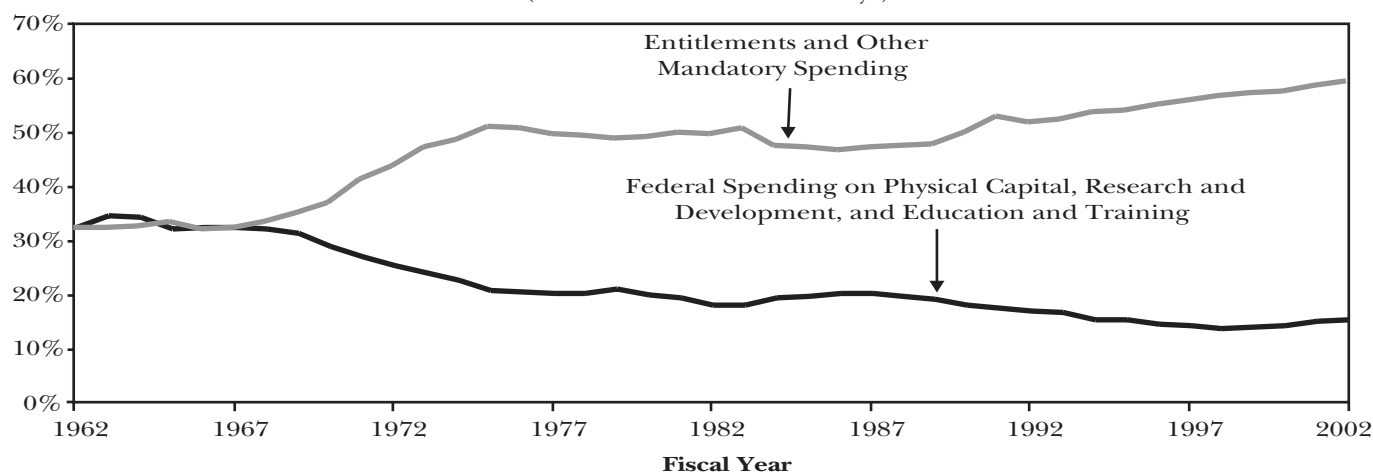
This is a different kind of “crowding out,” but one that reduces our net wealth today and our incomes tomorrow just as surely as reductions in domestic investment do. And these future income reductions are not just financial losses. When we borrow from abroad, we borrow not only financial capital but real goods and services, reflected in larger trade deficits. Ultimately, Americans must “pay back” those

goods and services (with interest), either as increased exports or diminished imports, which leaves less for consumption tomorrow.

Domestic and foreign “crowding out,” therefore, are simply two paths to the same end – a reduction of our society’s well being tomorrow to pay for today’s federal deficits and consumption. Figure 1-2 shows the extremely close relationship, again for 1960-2001, between federal deficits and total national investment, both domestic and foreign.

The linkage between budget deficits and our foreign investment raises an issue that has figured prominently in the deficit debate: do larger deficits raise interest rates? Elementary economic reasoning strongly supports such a relationship, and Federal Reserve Chairman Alan Greenspan has reaffirmed this view.⁴ Nevertheless, there has been considerable controversy about whether the numerous econometric studies on the subject confirm the relationship. A recent review of these studies, however, finds that, once expectations about *future* deficits are taken into account, a sustained increase in annual budget deficits of one percent of GDP can be expected to raise long-term interest rates by about 50 basis points after one year. We believe these findings support the common sense view that deficits raise interest rates, reduce domestic investment, and impair long-term economic growth.⁵

FIGURE 1-3
Federal Investment Declined as Entitlement Spending Grew
(As a Percent of Total Outlays)



Source: Congressional Budget Office (CBO), *The Budget and Economic Outlook: 2004-2013* (Washington, D.C.: CBO, January 2003), p. 152; Office of Management and Budget (OMB), *Budget of the United States Government for Fiscal Year 2004, Historical Tables* (Washington, D.C.: GPO, 2003), p. 155.

Moreover, focusing on the relationship between deficits and interest rates obscures a more fundamental point. As globalization proceeds and capital markets become more integrated, the impact of deficits on foreign investment (and on our current account balance) becomes larger. Twenty years ago, economists were surprised to discover that the large deficits of the 1980's triggered much more borrowing from abroad and smaller reductions in domestic investment than anticipated. Deficits financed by borrowing from abroad may not have large effects on interest rates, since foreign funds relieve the shortage of domestic saving. But this foreign borrowing leaves us heavily mortgaged and reduces our future income even if interest rates don't change. Thus, deficits *do* matter, even if we live in a globalized world that substitutes foreign borrowing for higher interest rates.

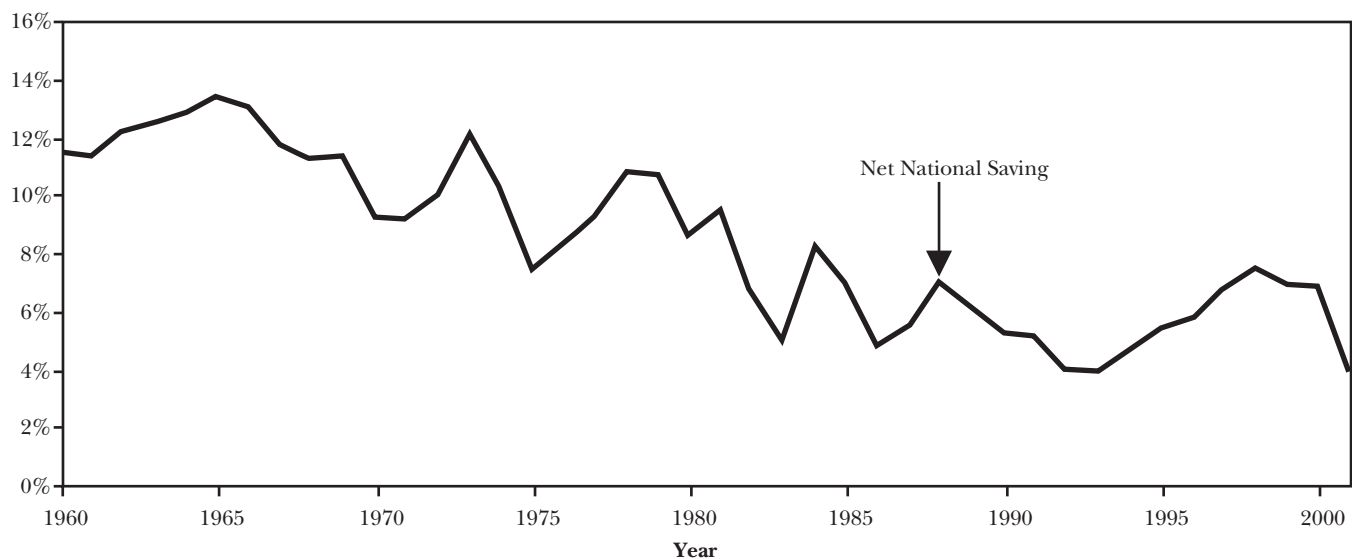
The relationship between deficits, saving, and private investment is not the only way that deficits affect long-term growth and our future standard of living. Two other dangers bear mentioning – the effects of deficits on productive public investments[†] and on economic stability.

CED has consistently been an advocate for productivity-enhancing public investments such as basic scientific research, improved public

schools, and expanded access to quality pre-school education.⁶ These public investments are a needed complement to private investment – basic research builds a store of knowledge that leads to future technological advances, workforce skills make new technologies more productive, and public infrastructure facilitates private business activity. But when budget deficits grow, there is a danger that desirable public investments will be cut back. First, these programs often lack the broad base of public support for the three largest items in the budget – national security, Social Security, and health care. Second, when deficits escalate, federal interest expenses also grow, leaving less of the budget available for “discretionary” uses such as public investment. As shown in Figure 1-3, federal expenditures on physical capital, research and development, and education and training have been a declining portion of the

[†] The U.S. National Income and Product Accounts (NIPA) include public expenditures on physical capital, such as structures, equipment, and software, in national saving and investment. Other public expenditures that raise future output and income, such as those on research and development, education, and training are not included in saving and investment and therefore add to the computed budget deficit. A comprehensive capital budget would include such expenditures in saving and investment, but the problems in defining genuine investment expenditures are acute.

FIGURE 1-4
The Long-Term Decline of National Saving
(Percent of Net National Product)



federal budget for many years, falling from about 34 percent of total expenditures in the early 1960's to about 15 percent today.⁷ The potential budgetary “crowding out” of these expenditures under the pressure of rising entitlement spending and larger deficits clearly poses a risk for long-term economic growth.

Finally, deficits that reduce our net foreign investment and leave a large stock of foreign claims against the U.S. not only reduce future income but make our economy (and, indeed, the world economy) potentially less stable. When any country's obligations to foreign investors grow large relative to its capacity to repay, there is an increasing risk that investors will begin to question the quality of those assets – that is, their total return, including especially the preservation of principal. Such a shift in market psychology can trigger a “run” – that is, an attempt by many investors to dump their assets on the market at the same time. When foreign lenders start dumping a country's assets, the results for the domestic economy can be disastrous, as recent experience in Asia, Russia, and Argentina testifies.

To be sure, the U.S. is not Argentina or Russia; the role of the dollar as the preeminent international reserve currency has been unique. But the U.S. economy will not be immune to sudden changes in interest rates, exchange rates, and asset prices if it comes to depend on ever-larger financial inflows, especially if the Euro begins to emerge as a competitive reserve

asset. How large our current account deficit and foreign indebtedness can grow before they become unsustainable cannot be determined with any precision, and will depend on the circumstances of the time. But both common sense and historical evidence suggest that borrowing from abroad cannot be limitless; at some point, foreign lenders will see escalating new borrowing as a threat to the value of their assets and react, to the detriment of the borrower.

The threat of rising foreign indebtedness is hard to quantify, given the uncertainties inherent in market behavior. And the effects of diminished long-term investment, while obvious, are also difficult to estimate, as noted in Chapter 3 below. But the fact of declining and inadequate saving is not. Figure 1-4 shows the U.S. national saving rate going back to 1960. CED has consistently focused on this disquieting trend during the past several decades, but the problem continues to get worse. Failure to save is not necessarily a harbinger of economic collapse; rather, it foreshadows a gradual and steady undermining of our well-being, more like arsenic poisoning or termites in the woodwork. A society that fails to put aside resources for tomorrow will not have a higher standard of living tomorrow. It is a death of a thousand cuts.

In the following chapter we examine the outlook for the federal budget and the likely size of the deficits that lie ahead if we continue on our present fiscal course.

Endnotes

1. Congressional Budget Office (CBO), *The Budget and Economic Outlook: Fiscal Years 2002-2011* (Washington, D.C.: CBO, 2001); CBO, *The Budget and Economic Outlook: Fiscal Years 2004-2013* (Washington, D.C.: CBO, 2003).
2. Committee for Economic Development (CED), *Economic Policy in a New Environment: Five Principles* (Washington, D.C.: CED, 2001).
3. CED, *How Economies Grow: The CED Perspective on Raising the Long-Term Standard of Living*. (Washington, D.C.: CED, forthcoming). While technological progress was traditionally considered to be “exogenous,” a large body of recent economic research has explored the ways in which investment and reorganization “feed back” to affect technology in a process of “endogenous” growth. For a summary see Gregory Mankiw, *Macroeconomics*, Fifth Edition (New York: Worth Publishers, 2002), Chapter 8, pp. 207-235; and Debraj Ray, *Development Economics* (Princeton, NJ: Princeton University Press, 1998), Chapters 3 and 4, pp. 47-129.
4. United States Federal Reserve Board, *Testimony of Chairman Alan Greenspan: Current Fiscal Issues*, Before the Committee on the Budget, U.S. House of Representatives (September 12, 2002), available at <http://www.federalreserve.gov/boarddocs/testimony/2002/20020912/default.htm>, accessed February 20, 2003.
5. William G. Gale and Peter R. Orszag, *The Economic Effects of Long-Term Fiscal Discipline* (Washington, D.C.: Urban-Brookings Tax Policy Center, 2002), p. 27.
6. CED, *America's Basic Research: Prosperity Through Discovery* (Washington, D.C.: CED, 1998); CED, *Preschool for All: Investing in a Productive and Just Society* (Washington, D.C.: CED, 2002).
7. Office of Management and Budget, *Budget of the United States Government for Fiscal Year 2004, Historical Tables* (Washington, D.C.: U.S. Government Printing Office, 2003), Table 9.1, p. 155.

Chapter 2

The Budget Outlook for the Next Decade

After a fifteen year struggle with ballooning deficits, the federal government finally brought its budget under control in the mid-1990's. In relation to the size of the economy, the deficits of the mid-1980's and early 1990's had reached levels not seen since World War II. Faced with this bleak budget picture, policymakers managed to strike a compromise in 1990 known as the Budget Enforcement Act (BEA). That law imposed caps on discretionary spending and established a pay-as-you-go (PAYGO) rule, requiring that policy changes that cut taxes or increased entitlement spending be paid for by changes in other tax or entitlement legislation.¹ This Act, in combination with rising revenues from the economic boom of the late 1990s, an increase in tax rates on upper incomes in 1993, and another bipartisan budget agreement in 1997, yielded the first string of four consecutive federal budget surpluses in the post-war period. It was a dramatic fiscal turnaround.

In the last several years, however, an economic downturn, new requirements for national and homeland security spending, and new budget policies have reversed this fiscal progress. Today, both budget surpluses and federal fiscal discipline seem like distant memories. This chapter tells the story of America's fiscal setback. We examine how the federal government has managed to dig itself again into a fiscal hole and show why that hole is deeper than is commonly recognized.

THE DISAPPEARING SURPLUSES

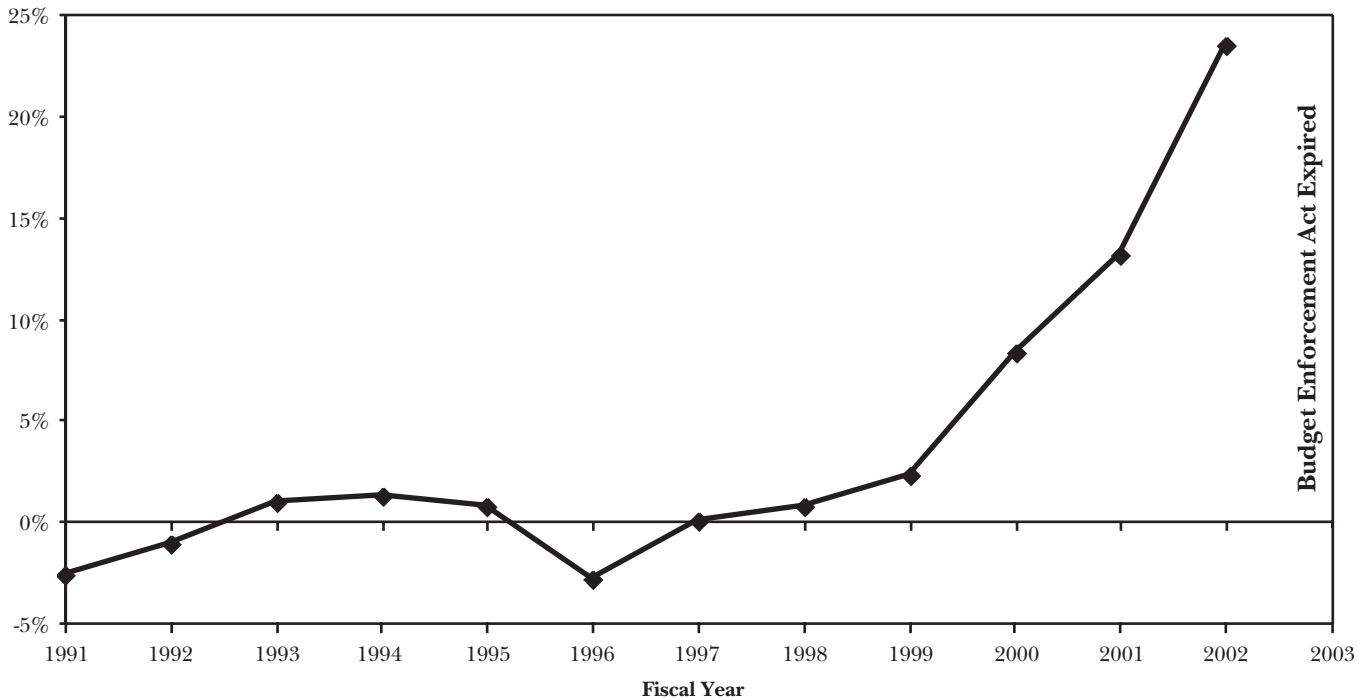
In just two years, encouraging official projections of an unending stream of large federal surpluses have given way to much darker forecasts that include substantial deficits. As of January 2001, the Congressional Budget Office

(CBO) was projecting a "baseline" (current policy) surplus of \$359 billion for the current fiscal year (2003), but, as of January 2003, this projected surplus had changed into a deficit of \$199 billion. (Indeed, the Administration's 2004 budget estimates this 2003 "baseline" deficit at \$264 billion.) This \$558 billion swing is equivalent to 5.2 percent of GDP for fiscal year 2003. For the rest of the decade, the numbers tell a similar story. All told, the large ten year cumulative surplus once projected for 2002-2011 has effectively disappeared, dropping from \$5.61 trillion in the January 2001 projection to \$0.02 trillion in January 2003.²

The story of the disappearing surpluses begins in the late 1990's. Even as the budget projections were growing rosier and rosier, the bipartisan budget process began to break down. With surpluses in hand, policymakers proceeded to circumvent the rules they had established to rein in budget deficits. After fiscal year 1998, when the first surplus emerged, Congress began evading the BEA by making large upward adjustments to the discretionary spending caps and by flouting PAYGO requirements. (In exploiting the "flexibility" provisions of the BEA, policymakers went so far as to declare the funds for the constitutionally mandated census in 2000 to be an "emergency" expenditure!) [See Figure 2-1] After five years of being evaded or ignored, the discretionary caps and PAYGO mechanism were allowed to expire in September 2002.

At the same time that BEA was becoming largely a dead letter, the overarching budget process established in the Budget Impoundment Act of 1974 was also increasingly disregarded. The Budget Impoundment Act was designed to rationalize the budget process by forcing Congress to set targets for spending, revenues,

FIGURE 2-1
Policymakers Have Broken Their Own Restraints on Discretionary Spending
 (Actual Spending Above or Below Originally Enacted Caps* as a Percent of Discretionary Spending)



*Adjustments for Desert Shield/Storm are excluded since the vast majority of the war's costs were paid back to the U.S. by foreign countries.

Source: Congressional Budget Office (CBO), *The Budget and Economic Outlook: Fiscal Years 2004-2013* (Washington, D.C.: CBO, January 2003), p. 115

and budget balance. However, in the last five years, the targets set in the budget resolutions were either violated by wide margins, or budget resolutions were not passed at all. [See Figure 2-2] The self-imposed budget process, intended to guide and restrain Congressional policymakers, was broken, and the political stage was set for a rapid return to budget deficits.³

Unsurprisingly, discretionary spending began a sharp ascent in the late 1990's. After falling (in inflation-adjusted terms) since fiscal year 1991, with the help of the "peace dividend" occasioned by the end of the Cold War, discretionary spending turned upwards in 1999. From 1998 through 2002, real discretionary spending jumped 21 percent.⁴ Then, with President George W. Bush's arrival in office, tax cuts rose to the top of the policy agenda. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was the centerpiece, cutting revenues and reducing projected surpluses by over \$1.6 trillion (including interest) from 2002 through 2011.⁵

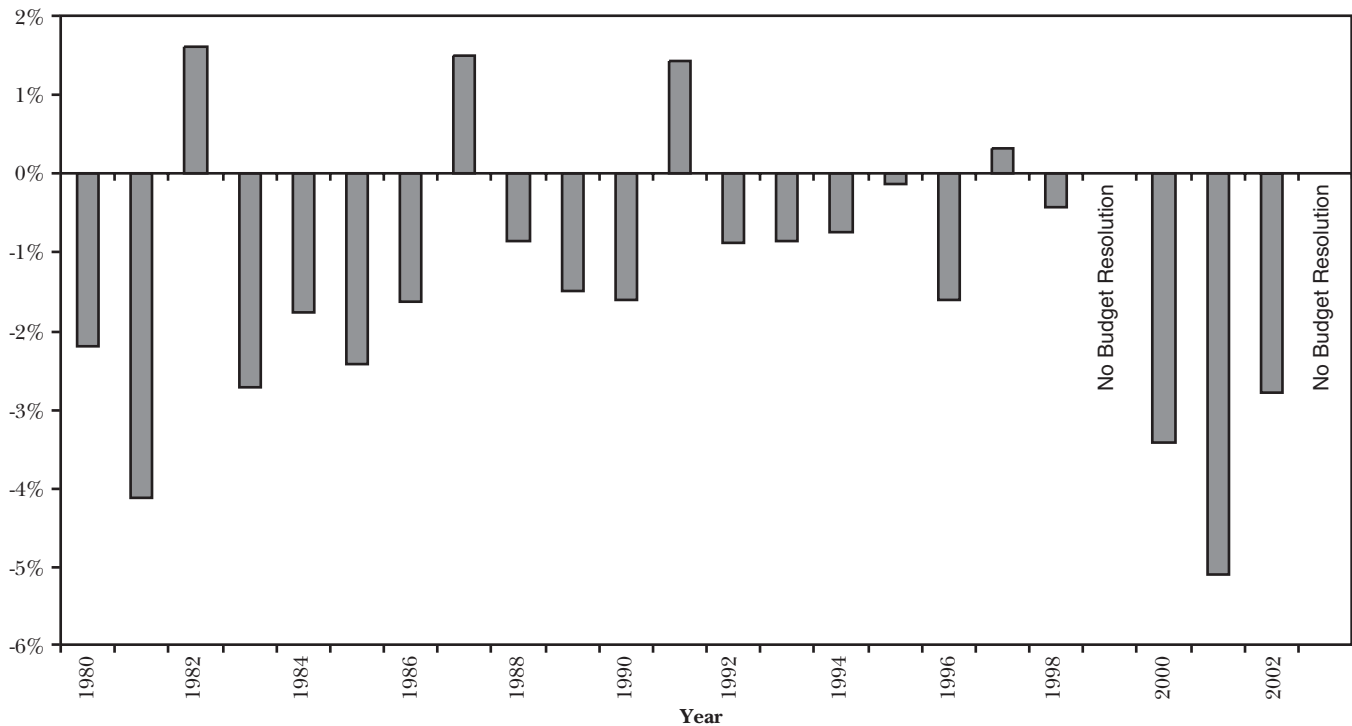
With policymakers having spent or rebated

in tax cuts much of the projected surpluses, the economic slowdown that began in early 2001 aggravated an already deteriorating fiscal situation. Revenues fell with slowing economic activity and falling employment, and the precipitous stock market drop hit the projected surpluses especially hard. The flood of federal revenues from capital gains realizations and other sources during the late 1990's dramatically dried-up. Altogether, between January 2001 and January 2003, such "economic and technical changes"* accounted for a remarkable \$2.6 trillion reduction (including interest) in the projected ten year surplus for 2002-2011.

Taking the decade as a whole, CBO's estimates indicate that 54 percent of the fall in the ten year cumulative surplus can be attributed to

* In the CBO projections, "technical changes" include changes in estimated capital gains revenues as well as other estimating changes, including many with a significant economic component. "Economic changes" essentially reflect budget changes due to changes in the CBO economic forecast of output, incomes, prices, interest rates, etc.

FIGURE 2-2
Congressional Budget Resolutions No Longer Guide Fiscal Policy
 (Policy Violations* as a Percent of Total Outlays)



* A "policy violation" is the difference between the actual budget deficit and the deficit set in the budget resolution that derives from enacted legislation not anticipated in the resolution or legislation that cost more or less than the resolution assumed.

Source: Adapted from Rudolph Penner, *Repairing the Congressional Budget Process* (Washington, D.C.: The Urban Institute, 2002), p. 8; Congressional Budget Office (CBO), *Budget and Economic Outlook: 2004-2013* (Washington, D.C.: CBO, January 2003), pp. 124-129 and p. 152.

changes in budget policies (including 30 percent due to EGTRRA and 22 percent due to increased spending), while the remaining 46 percent is a result of economic and technical changes.⁶ However, it is important to note that the effects of the economic and technical changes are much larger in the first half of the decade, reflecting the budgetary effects of the recent economic downturn. As Table 2-1 shows, by the end of the decade – and reaching into the future – policy changes are far more important. Thus, by fiscal year 2010, policy changes account for almost two-thirds (63 percent) of the deterioration in the surplus, whereas economic and technical factors are associated with only 37 percent. In short, while a substantial portion of the current fiscal deterioration can be blamed on the economy, responsibility for the fiscal set-back in later years lies squarely on the shoulders of policymakers.

A separate but parallel problem exists for state budgets. States were awash in revenues

during the boom of the late 1990's, but are now retrenching rapidly, drastically cutting expenditures and in some cases raising taxes to address an estimated aggregate deficit of \$50 billion this fiscal year and between \$70 and \$85 billion the next.⁷ This necessary fiscal retrenchment will impede national economic recovery, even while the federal budget has become more expansive.

The circumstances of individual states differ, but almost all states operate under borrowing restrictions that require them to take prompt action. Thus, state fiscal deficits are likely to be relatively short-lived when compared with those of the federal government, although their programmatic cutbacks will cause significant economic and social problems. The states' fiscal retrenchment is therefore important, not only for its macroeconomic impact, but also because the federal government may attempt to solve its own problems by passing them back to the states, sometimes by imposing unfunded mandates. We

TABLE 2-1
Policy Changes Account for Almost Two-Thirds of the Long-Term Fiscal Deterioration
 (January 2003 Projection Compared to January 2001 Projection)

	2002-2003 Average		2010	
	Reduction in Surplus Due to Various Factors (Billions of Dollars)	Proportion of the Deterioration for Which Each Factor Accounts	Reduction in Surplus Due to Various Factors (Billions of Dollars)	Proportion of the Deterioration for Which Each Factor Accounts
Surplus Projected in January 2001	336		796	
Changes Due to Legislation	-201	39%	-411	63%
2001 Tax Cut (EGTRRA)	-69	13%	-259	40%
Other Tax Legislation	-45	9%	3	0%
Defense	-46	9%	-95	15%
Non-Defense Discretionary (Including Homeland Security)	-21	4%	-40	6%
All Other Legislation	-22	4%	-20	3%
Changes Due to Economic and Technical Factors	-314	61%	-245	37%
Total Reduction in Surplus	-515	100%	-655	100%
Surplus Projected in January 2003	-178		140	

Source: Center on Budget and Policy Priorities (CBPP), *Why the Surplus Has Disappeared* (Washington, D.C.: CBPP, 2002); Updated January 2003.

do not know the full extent of these mandates, but they are currently growing, to varying extents, in areas such as educational testing and assessment and front-line homeland security. Moreover, they may increase in areas such as welfare reform, where the upcoming reauthorization may impose stricter work requirements, and in Medicaid, where the Administration is propos-

† We acknowledge that deficit projections ten years into the future are extremely uncertain, not only with regard to policy actions, but also (and perhaps especially) with regard to the effects of changes in the economy, the costs of legislated programs, and other variables. (See CBO, *The Budget and Economic Outlook: Fiscal Years 2004-2013*, Chapter 5.) However, we do not believe that this uncertainty implies that we “know nothing” about the likely ten-year budget path and can therefore ignore the projected effects of the decisions we take. First, the budgetary effects of the *policy changes* we make are far less uncertain than the *levels* of the deficits or surpluses that will finally result, so we know a great deal about the *impacts* of those policies on the deficit. Second, and perhaps more important, *the large estimating uncertainty itself dictates that we should be more prudent in our budget policies than if the projections were more certain.* The costs of the inevitable errors in deficit projections are very asymmetric: It is politically very difficult to raise taxes or cut spending to address unexpectedly large deficits, whereas tax cuts or spending increases to address unexpectedly large surpluses present no such problem.

ing further devolution to the states in the face of rapidly rising costs. In all these cases, there is the risk that activities will be mandated of the states, or turned back to them, with no offsetting long-term revenue sources.

DEFICITS “AS FAR AS THE EYE CAN SEE”

In spite of their sharp deterioration since January 2001, the CBO January 2003 projections do not begin to gauge the likely magnitude of our fiscal predicament. Those projections show the federal government pulling into the clear by the middle of the decade, with surpluses projected from fiscal year 2007 onwards. There would seem to be little reason to worry unduly about long-term deficits if budget surpluses were to be soon restored – even if they were significantly smaller than once expected. But, this projected upswing in the fiscal position is unlikely to occur, since the projections are based on unrealistic assumptions about future policy decisions.†

The most striking lack of realism in the projections is the assumption (legally required of CBO) that EGTRRA will expire as provided in current law, as will other smaller tax reductions. In order to evade budget rules that would have restricted its size, EGTRRA was written to expire after 2010; the tax code would then revert to its pre-EGTRRA status. For example, under current law the estate tax will be fully repealed at the end of 2010 but in 2011 will return to its pre-2001 rates and exemptions, as will individual rate brackets and the other features of the code modified in EGTRRA. No one believes this will happen. Indeed, since the day EGTRRA arrived on his desk, President Bush and many in Congress have sought to make EGTRRA permanent, and that has now been proposed in the Administration's 2004 budget. While some modifications are likely, it is widely expected that the basic policies of EGTRRA will be extended – especially the individual rate reductions, child credit, and marriage penalty relief, which account for over 80 percent of the long-term revenue reduction. Other tax provisions whose expiration would raise revenues will also almost certainly be extended, as has consistently been the practice in the past. As shown in Figure 2-3, these extensions would dramatically raise the path of federal deficits, especially after fiscal year 2010. Over 2004-2013, making all expiring tax cuts permanent would reduce revenues by \$1.2 trillion and raise the cumulative deficit by \$1.4 trillion (including interest).⁸ The effects on deficits in the following decade, of course, would be far greater.

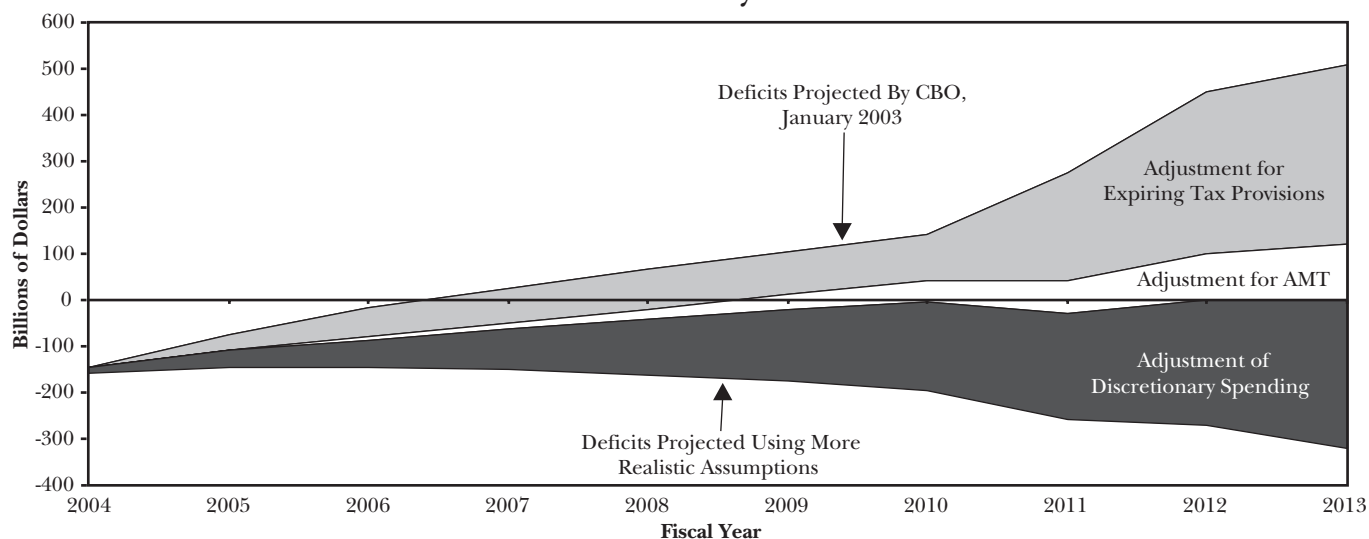
The CBO projections overestimate the federal government's likely revenue stream in another critical respect. It is universally recognized that the alternative minimum tax (AMT) is dysfunctional. The AMT was designed in the 1960's to curb aggressive tax avoidance, but was never intended to apply to a significant proportion of taxpayers. Among other problems with the AMT, its exemptions, brackets, and phase-outs are not indexed to inflation, bringing more and more taxpayers under the minimum tax even if their real incomes do not rise. In addition, the tax rate reductions in EGTRRA, by

reducing regular income tax liabilities, make more taxpayers subject to the AMT. In 2002, some 2.6 million taxpayers faced the AMT; by 2010, it is projected to apply to 36 million taxpayers – 33 percent of all filers.⁹ Again, no one expects this to happen. A reform of the AMT to limit its application is a foregone conclusion, and the administration is already proposing "temporary" limitations. As shown in Figure 2-3, merely indexing the AMT to inflation starting in 2003 would raise the ten-year cumulative deficit by \$411 billion (including interest).¹⁰

Finally, with the U.S. gearing up to meet new national defense and homeland security requirements, including possible war, reconstruction, and nation-building in Iraq, discretionary spending is likely to grow much faster than assumed by the CBO. The CBO baseline (by law) assumes that inflation-adjusted discretionary spending will remain unchanged over the ten-year projection period. Events of recent years belie this optimism. From fiscal year 1999 through fiscal year 2002, annual growth in real discretionary spending has averaged five percent.¹¹ The Administration has been planning to increase real national security spending by about four percent annually during this decade – before accounting for any additional costs related to Iraq, which have been estimated to run anywhere from \$100 billion to \$2 trillion.¹² Homeland security spending to defend against terrorist attack at home is likely to raise non-defense discretionary spending, which, in any case, has grown on average at about the same rate as the economy since the 1960's. Thus, it appears virtually certain that real discretionary spending will increase during this decade. As a matter of prudent budgeting, it seems reasonable to assume that total discretionary spending will grow *at least* as rapidly as the economy during the next few years. This assumption would add nearly another \$1.5 trillion (including interest) to CBO's projection of the cumulative federal deficit during 2004-2013.¹³

As Figure 2-3 shows, these more realistic assumptions about expiring tax provisions, revisions to the AMT, and the growth of discretionary spending lead to deficit projections very

FIGURE 2-3
Projections Based On More Realistic Assumptions* Show Deficits
“As Far as the Eye Can See”



*Assuming that expiring tax provisions are not allowed to sunset, that AMT is indexed to inflation, and that discretionary spending/GDP is held constant.

Source: William Gale and Peter Orszag, *Perspectives on the Budget Outlook*, (Washington, D.C.: Brookings Institution, 2003), Appendix Table 3; Congressional Budget Office (CBO), *Budget and Economic Outlook: 2004-2013* (Washington, D.C.: CBO, January 2003).

different from those of CBO.¹⁴ Instead of a \$1.3 trillion ten year surplus, the projections show a deficit of about two trillion dollars. And rather than large and growing budget surpluses in the next decade, the adjusted projections show annual deficits of \$300-400 billion, increasing “as far as the eye can see.” These projections are not a *prediction* of budget outcomes, since policies can and should be adopted to change those outcomes; we recommend such policies in Chapter 4. But the projections are a reasonable portrayal of the ten-year budget path *on which we are currently traveling* and the size of the budget problem that lies immediately ahead.[‡]

These projections, however, are not yet the end of the story of our possible fiscal predicament, for they do not take account of the Administration’s latest budget proposals. The newly-proposed “jobs and growth” tax cut package would end the individual taxation of dividends paid from retained earnings, accelerate scheduled income tax rate cuts, accelerate marriage penalty relief, and accelerate and expand the child tax credit. This proposal is estimated to reduce federal revenues during 2004-2013 by \$665 billion, and raise the cumulative deficit

(including interest) by about \$920 billion.¹⁵ In addition, the Administration’s other budget proposals, including the permanent extension of EGTRRA, would increase the ten-year deficit by about \$1.8 trillion. All told, the new budget proposals, if enacted, would raise the ten-year deficit by about \$2.7 trillion and annual deficits ten years from now by about \$500 billion. The 2013 deficit of \$300-325 billion projected in Figure 2-3 would be raised by \$200-250 billion to about \$500-575 billion, after accounting for Administration proposals (or similar policies) already included in that projection.¹⁶ Moreover, these projections do not include expenditures related to a possible war and subsequent reconstruction in Iraq.

A decade of these growing deficits will leave

‡ The projections in Figure 4 are not, however, a reasonable portrayal of the stance of our long term fiscal policy, looking out several decades. The unified budget’s cash accounting system is inadequate, and indeed highly misleading, for this purpose, since it does not recognize heavy future spending commitments for public pensions and health care costs, but does include current receipts set aside to fund some of those commitments. The net present value in 2001 of unfunded liabilities for Social Security, Medicare, and Federal employee and veterans’ pension benefits was about \$20 trillion. See U.S. Treasury, *Financial Report of the United States Government for Fiscal Year 2001*, pp.10, 58.

America ill-prepared for the arrival of the baby-boomers' retirement. In Chapter 1, we explained why such large federal deficits are detrimental to the long-term growth of national income. In the next chapter, we explore why it

is particularly inappropriate for today's Americans to be borrowing against future income, by tracing out the economic and budgetary ramifications of the aging of the U.S. population.

Endnotes

1. Rudolph Penner, *Repairing the Congressional Budget Process* (Washington, D.C.: Urban Institute, 2002), p. 8.
2. Congressional Budget Office (CBO), *The Budget and Economic Outlook: Fiscal Years 2003-2012* (Washington, D.C.: CBO, January 2002); CBO, *The Budget and Economic Outlook: An Update* (Washington, D.C.: CBO, August 2002); CBO, *The Budget and Economic Outlook: Fiscal Years 2004-2013* (Washington, D.C.: CBO, January 2003).
3. For a thorough description of the breakdown in budget process, see Penner, *Repairing the Congressional Budget Process*.
4. Office of Management and Budget (OMB), *Fiscal Year 2004 Historical Tables: Budget of the U.S. Government* (Washington, D.C.: GPO, 2003), Table 8.2, p. 124.
5. CBO, *The Budget and Economic Outlook: An Update* (August 2002).
6. William Gale and Peter Orszag, *Perspectives on the Budget Outlook* (Washington, D.C.: Brookings Institution, 2003), Table 2.
7. Iris J. Lab and Nicholas Johnson, *State Budget Deficits for Fiscal Year 2004 are Huge and Growing* (Washington, D.C.: Center on Budget and Policy Priorities, January 2003).
8. CBO, *The Budget and Economic Outlook: Fiscal Years 2004-2013*, Table 3-11, pp. 72-73; Gale and Orszag, *The Vanishing Budget Surplus*, Appendix Table 3.
9. Leonard Burman, William Gale, Jeffrey Rohaly, and Benjamin Harris, *The Individual AMT: Problems and Potential Solutions*, Discussion Paper No. 5 (Washington, D.C.: Urban-Brookings Tax Policy Center, 2002), p. 6.
10. The AMT exemption has been increased for 2001 to 2004, but it is scheduled to revert to its 2000 level starting in 2005. The law increasing the exemption is expected to be made permanent. The costs of making the increased AMT exemption permanent are included in calculating how much the federal government would lose in revenues by extending all tax provisions scheduled to expire. In itself, making the increased exemption permanent would cost the federal government \$191 billion from 2004-2013, not including interest. (See Gale and Orszag, "Perspectives on the Budget Outlook," p. 5 and Table 3.)
11. OMB, *Budget of the United States Government for Fiscal Year 2004, Historical Tables*, Table 8.2, p. 124.
12. William D. Nordhaus, "The Economic Consequences of a War With Iraq," in Carl Kaysen, Steven E. Miller, Martin B. Malin, William D. Nordhaus, John D. Steinbruner, *War with Iraq: Costs, Consequences and Alternatives* (Cambridge, MA: American Academy of Arts and Sciences, 2002), pp. 51-85.
13. CBO, *The Budget and Economic Outlook: Fiscal Years 2004-2013*; CED interest estimates computed from CBO interest matrix, January 2003.
14. These revisions to the CBO projections are summarized in Gale and Orszag, *Perspectives on the Budget Outlook*.
15. United States Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals* (Washington, D.C.: Department of the Treasury, 2003), pp. 151-153; CED interest estimates based on CBO interest matrix.
16. See OMB, *Budget of the U.S. Government*, Tables S-3, S-9, S-10; U.S. Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, pp. 151-153. The Administration provides five-year annual estimates of all its budget proposals, ten-year annual estimates of its revenue proposals, and cumulative ten-year estimates of its mandatory spending proposals. These estimates, adjusted to include interest costs estimated from the CBO interest matrix, indicate that the 2004-2013 ten-year deficit would be increased by about \$1.6-1.7 trillion by the revenue proposals and \$700 billion by the mandatory spending proposals. (*The General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals* contain the revised and apparently official estimate of the proposal to eliminate the double taxation of corporate earnings. This estimate is not reflected in the Administration's summary tables in the budget, which thereby understate the revenue and deficits impacts of the proposal.) While the Administration does not provide discretionary spending estimates for 2009-2013, a conservative assumption of zero real growth in discretionary spending during this period yields an estimate of about \$360 billion for the ten-year deficit impact. This gives a total of about \$2.7 trillion. The annual deficit estimates for 2013 are derived from the same sources and assumptions but exclude the Administration proposals for increased discretionary spending, extensions of expiring tax cuts, and limitations on the Alternative Minimum Tax, which are subsumed in the policies assumed in Figure 2-3. Details available from CED upon request.

Chapter 3

The Impending Threat to America's Living Standards

America faces a major demographic transition. In just five years, the first baby boomers will begin drawing early-retirement Social Security checks at age 62. America will then enter a new era characterized by rapid expansion of retirees coupled with extremely slow growth in the working age population. By 2025, the proportion of the entire U.S. population over 65 will be greater than in the state of Florida today.¹ This dramatic transformation of U.S. demographics will have serious implications for the American economy.

These implications have been primarily discussed in the context of the Social Security system. Social Security currently is running surpluses, but it is projected to pay out more than it takes in beginning in 2017 and to exhaust its accumulated trust fund balances just after 2040.² Social Security's potential insolvency represents a serious problem that should be resolved swiftly and responsibly. Nevertheless, in focusing so intensively on Social Security's accounting problems, the country has tended to ignore the more fundamental economic problems posed by the demographic transition.

The national debate has not addressed the overarching issue of how the aging of the population will affect Americans' general standard of living. It has not addressed the fact that the demographic transition will put pressure on consumption standards, potentially causing our society to cut national saving and thereby slow economic growth. These are the topics taken up in this chapter, which is concerned with how the health of the American economy as a whole – and not particular government programs – could be endangered by the aging of the population if we do not follow appropriate policies.

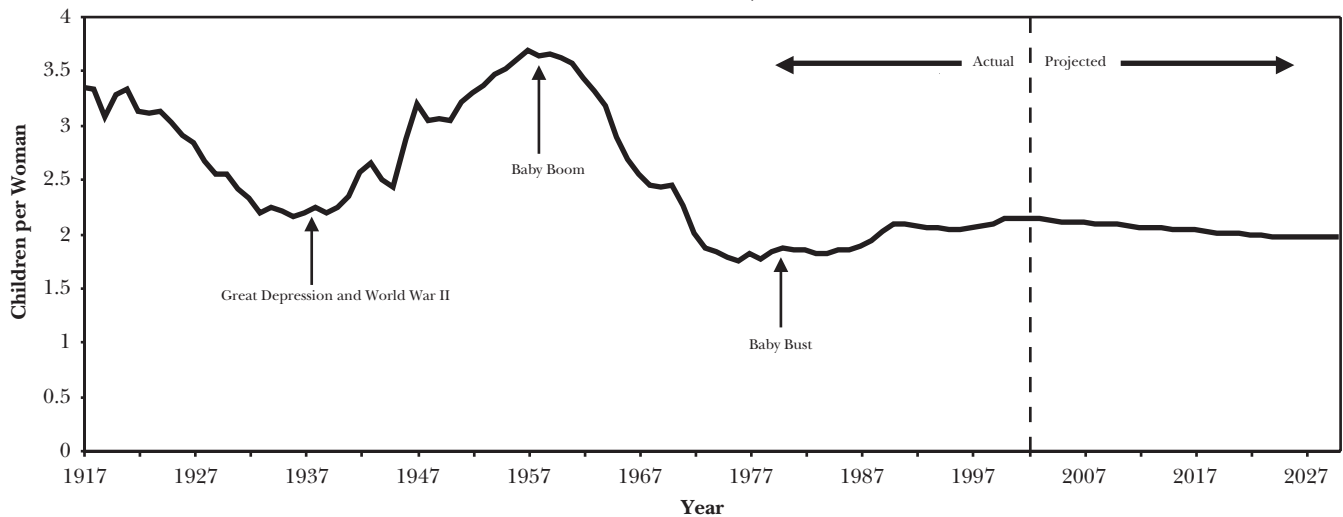
AMERICA'S CHANGING AGE DISTRIBUTION

Changes in fertility rates and lifespan have, in combination, produced a rapid aging of the American population. Figure 3-1 shows the bulge in the birth-rate between 1946 and 1964 – the years associated with the arrival of the baby boom generation. As can also be seen in Figure 3-1, immediately following the baby boom came the dramatic and still-enduring baby bust. Since the late 1960's, the U.S. fertility rate has remained well below the rates experienced in the three decades before the baby boom, including the years of the Great Depression and World War II.³ The baby boom and bust will soon translate into large numbers of Americans retiring with relatively few, younger Americans growing-up to take their place.

In addition to a fall in fertility, the U.S., over the last 50 years, has experienced a dramatic increase in the lifespan of the elderly. Since 1950, the life-expectancy of a 65 year old male has increased by 23 percent.⁴ [See Figure 3-2] With the elderly living longer and the baby boomers retiring, the population 65 and over is projected to rise from just 13 percent of the total population in 2010 to nearly 20 percent in 2030.⁵

This graying of America is not an ephemeral phenomenon that will disappear with the baby boomers. The proportion of the population over 65 is projected to continue growing throughout the century – far beyond 2030, when all baby boomers will have reached retirement age. In this very long-term, the principal engine of population aging is expected to be a continued rise in elderly life expectancy. Between now and 2080, life

FIGURE 3-1
The Baby Boom Has Been Followed by the Still Enduring Baby Bust
 (U.S. Total Fertility Rate*)



*The total fertility rate is the average number of children who would be born to a woman in her lifetime if she were to survive the entire childbearing period and experience the age-specific birth rates pertaining to the selected year.

Sources: 2002 OASDI Trustees' Report, Table V.A1, Intermediate Cost Assumptions; Felicitie Bell, *Social Security Administration Area Projections: 1997* (Washington, D.C.: Social Security Administration, 1997).

expectancy for a 65 year-old male is projected to jump another 28 percent.⁶ [See Figure 3-2] The fertility rate will also play a role in the long-term aging process because it is expected to remain relatively low and stable, no acceleration in fertility would offset the effects of longer elderly life expectancy. Looking far ahead in the century, the elderly will continue to live longer and relatively few children will continue to be born, making America's aging a very long-term, if not permanent, trend. These fundamental trends in fertility and life expectancy are likely to be mitigated only to a small degree by immigration, which itself has become highly uncertain in the near term due to political and national security concerns.

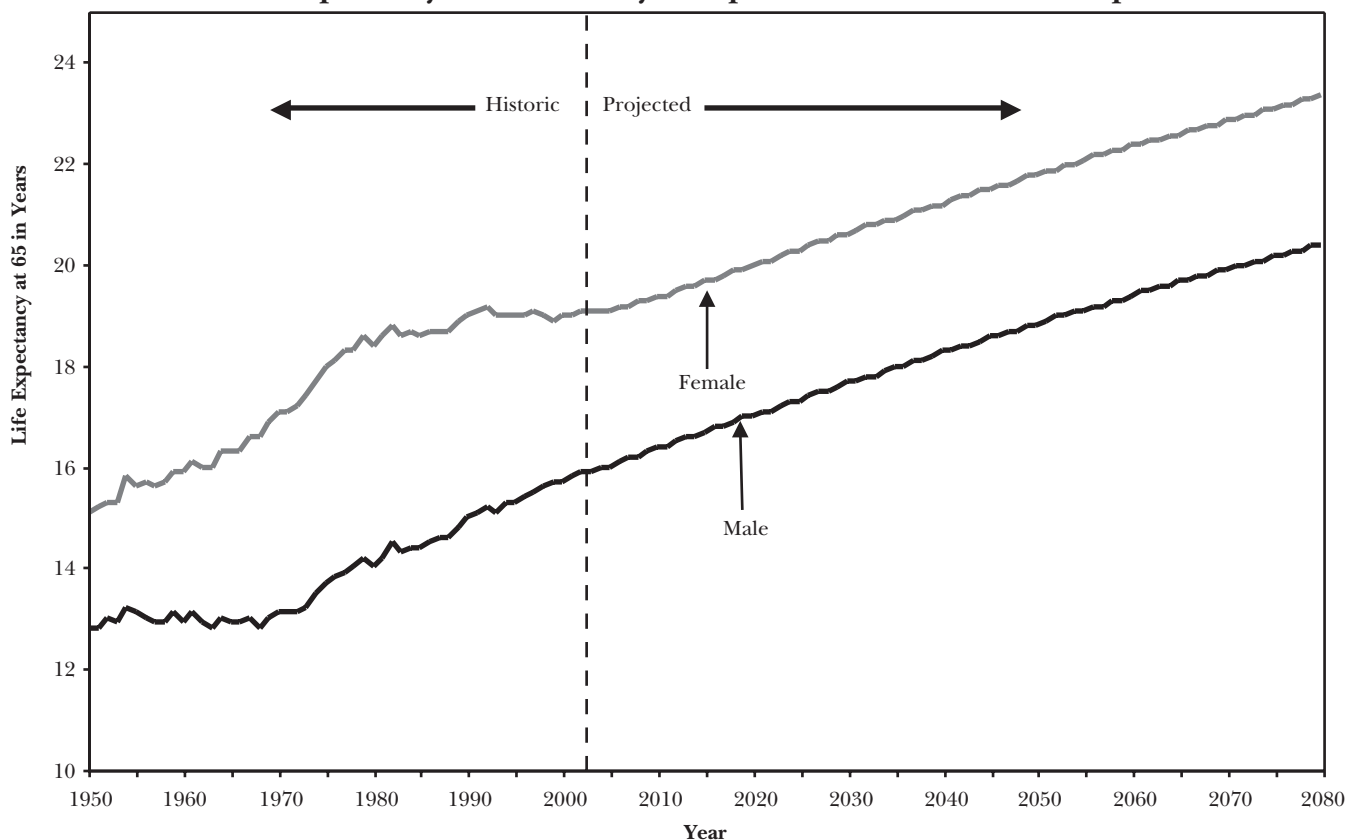
THE PRESSURES TO REDUCE NATIONAL SAVING: THE ECONOMICS OF AN AGING POPULATION

The demographic transition will translate into fewer workers per retiree. Over the next 75 years, annual growth in the working age population (those between age 20 and 64) is projected to average just 0.3 percent per year – with low birth rates and immigration providing just

enough new people of working age to replace those retiring. Indeed, growth in the native-born working age population will slow sharply during the next ten years, and their numbers will actually decline in the following decade; most net labor force growth will have to come from immigration, which is uncertain and fraught with a number of other issues.⁷ Over this same 75 year period, the population of retirement age is expected to grow at an annual rate of 1.3 percent. As time goes on, therefore, a growing number of retirees must be supported by the production and income of relatively fewer workers. This trend can be expressed as the elderly dependency ratio – the ratio of the elderly population to that of working age. Between today and 2080, it is projected to more than double. ^{*,8} [See Figure 3-3]

* In this same time period, the child dependency ratio – the ratio of those under age 20 to those between 20 and 64 – is projected to dip, as a result of gradually falling fertility. Nevertheless, this drop is rather slight – from 0.49 to 0.43 between 2000 and 2080 – and does little to counter the impact on dependency of the rapidly increasing number of retirees. Between 2000 and 2080, the total dependency ratio still jumps some 23 percent. This point is reinforced when consumption is taken into account. The costs of supporting a retiree are higher, and can be expected to rise much more rapidly, than the costs of supporting a child, due to the skyrocketing price tag of health care for the elderly.

FIGURE 3-2
Life Expectancy for the Elderly is Expected to Continue Its Sharp Rise*



*Life expectancy for a given year represents the average number of years of life remaining if a group of persons at age 65 were to experience the mortality rates for that year over the course of their remaining life.

Sources: 2002 OASDI Trustees' Report, Table V.A, Intermediate Cost Assumptions.

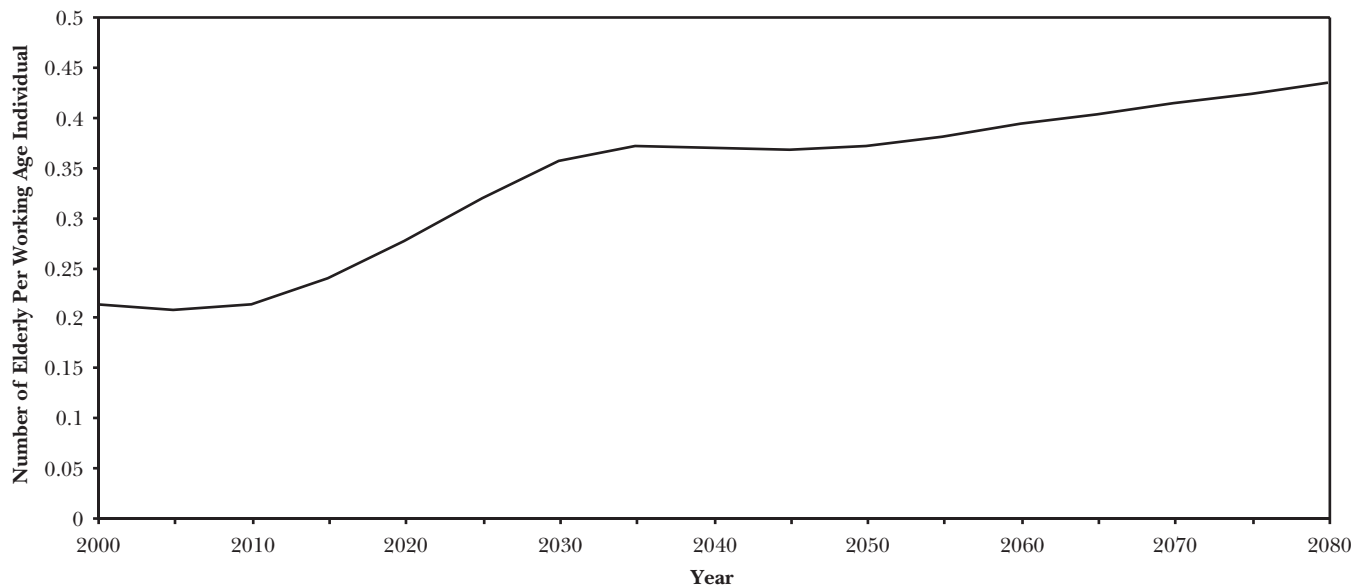
The combination of a non-growing workforce and a rapidly growing number of dependents will put a brake on U.S. income growth – both in absolute and per capita terms. In absolute terms, GDP growth can be expected to decline as the expansion of the workforce slows to a snail's pace; fewer workers in the office and on the production lines simply translate into less output. But at the same time that the growth of total output slows, the number of dependents will be increasing. The nation, therefore, will have to cut a more slowly growing GDP pie into smaller slices as the growth of average per capita income declines.⁹

Slower income growth means fewer dollars with which to save and consume, so that larger proportions of income will be required to maintain the same growth in consumption standards.

In addition, Americans will be faced with greater consumption needs. Due to the high cost of medical care, the consumption level of a 70 year-old retiree, on average, far exceeds the consumption level of a 30 year-old. By one estimate, the average elderly American consumes 37 percent more than the average worker, much of which is accounted for by public expenditures on health care.¹⁰

Thus, future Americans will be in a vice – squeezed on one side by sluggish income growth and, on the other side, by increased health care costs. Working households could expect to pay more to support the elderly both directly, for their own elderly family members, and indirectly, through their tax bills. These households would then have less to spend on themselves or to save. The elderly, too, would

FIGURE 3-3
Over the Next 75 Years, Elderly Dependency is Projected to More Than Double



Source: 2002 OASDI Trustees' Report, Table V.A2, Intermediate Cost Assumptions.

face cutbacks. They could expect less direct help from their families and reductions in government pension and health care benefits.

Such a squeeze on consumption would be difficult and painful. But would it occur? By reducing national saving and shifting those resources to consumption in both the public and private sectors, our society could temporarily avoid the hardship of retrenchment – but only by effectively borrowing further from future generations.

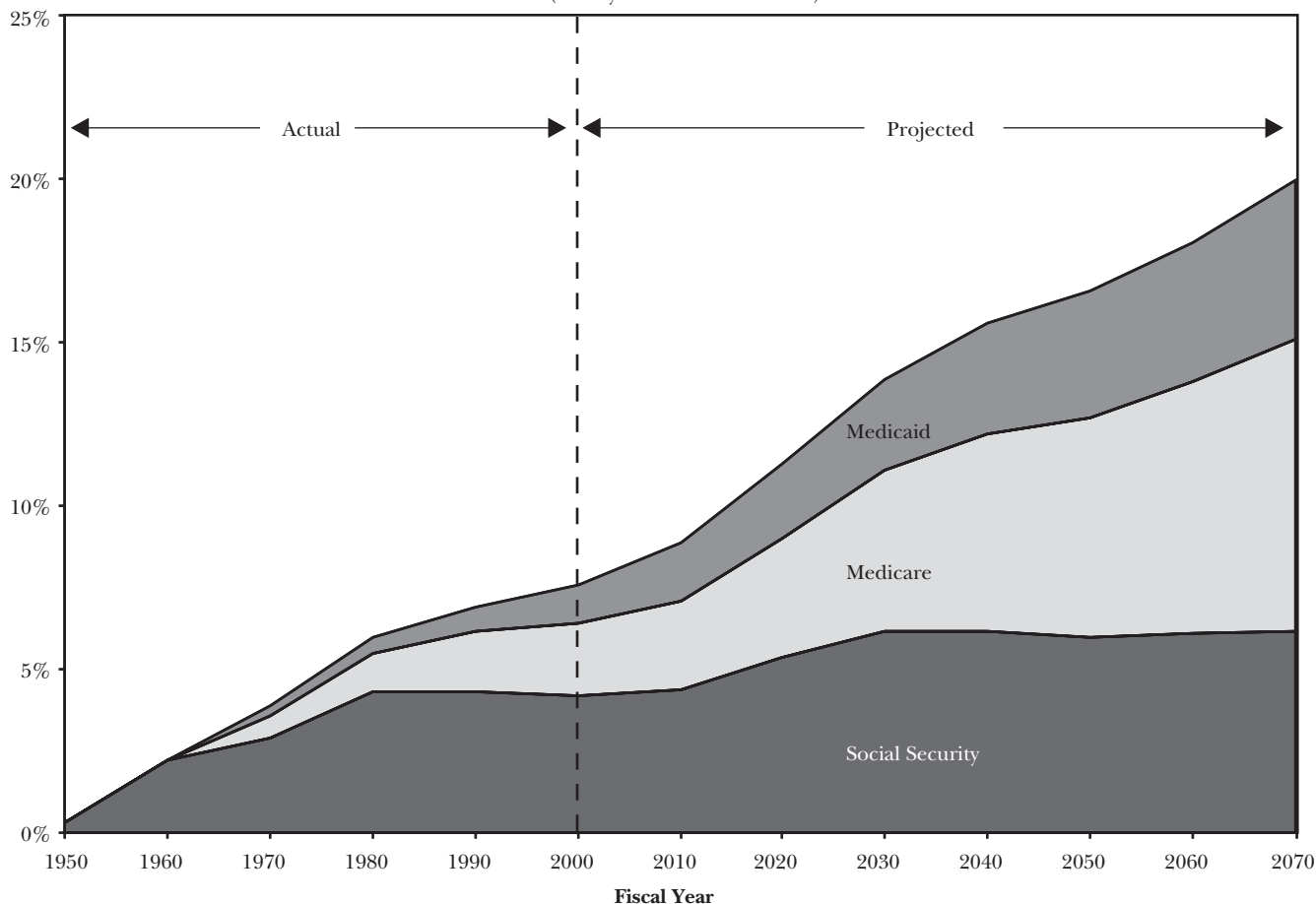
In the face of these demographic and economic pressures, the public sector poses the primary threat to national saving. The federal government is expected to bear much of the cost of the population's aging. Currently, three federal programs – Social Security, Medicare, and Medicaid – provide some 60 percent of total consumption by the elderly.¹¹ The federal government has enormous difficulty in adopting far-sighted policies, especially when those policies require fiscal austerity. Ideally, the government would protect the economic interests of both current and future generations. But, short-sightedness tends to plague policymaking. There is a great danger that policymakers will

avoid the painful fiscal adjustments that should be undertaken now and during the demographic transition, at least before we finally reach a social and economic crisis. Compared with significantly restraining public consumption expenditures and increasing taxes, policymakers are likely to find deficit spending to be the far easier road to walk.

Indeed, our current policies already put America on a trajectory towards massive government borrowing (or tax increases). Projections for Social Security, Medicare, and Medicaid show expenditures under the existing programs skyrocketing in coming years. As of 2002, outlays for these three programs amounted to an already considerable 7.6 percent of GDP. An aging population receiving Social Security benefits that keep pace with wage growth and (especially) the rising costs of medical care are projected to push these outlays up to about 14 percent of GDP by 2030 and some 20 percent of GDP by 2070, as shown in Figure 3-4.

Unless taxes were to rise dramatically to economically damaging and politically infeasible levels, this skyrocketing federal spending would produce a rapidly deteriorating fiscal position. One measure of this long-term budget crunch is

FIGURE 3-4
Long Term Pension and Healthcare Expenditures Will Explode
 (Outlays as a Percent of GDP)



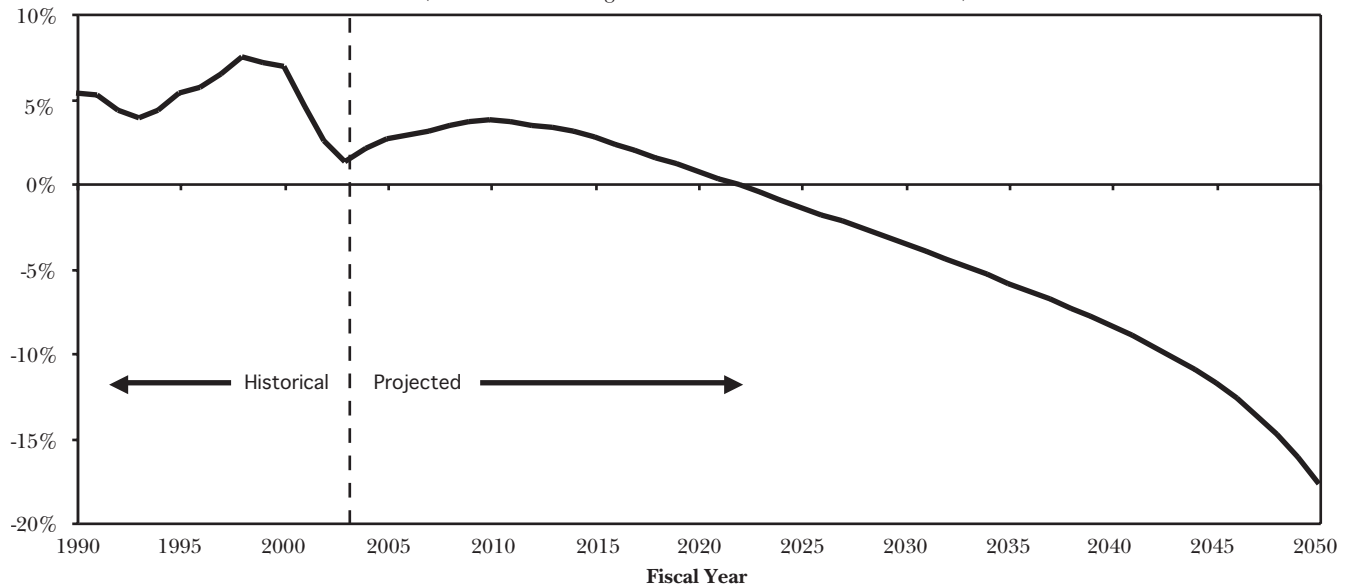
Source: Congressional Budget Office (CBO), *Long Range Fiscal Policy Brief: A 125 Year Picture of the Federal Government's Share of the Economy, 1950 to 2075*, (Washington, D.C.: CBO, July 2002), p. 3.

the “fiscal gap” – the size of the *immediate* and *permanent* reduction in expenditures and/or increase in taxes required to keep government debt from growing faster than GDP. It is a rough measure of how far we are from running the government on a sound actuarial footing and reflects in large part the future costs of unfunded obligations in federal entitlement programs. CED estimates that the federal fiscal gap through 2075 is nearly five percent of GDP.¹² This implies that, to keep the federal debt from growing at an unsustainable rate over this longer term, the federal government would have to immediately cut spending or increase taxes by roughly \$500 billion *per year* – about a 23-26 percent reduction in expenditures or

increase in taxes – and maintain these policies as an equivalent proportion of GDP in future years.

At the same time that the federal government may be deep in the red, households will be strongly pressed to squeeze their personal saving to maintain their consumption standards. Certainly, as the baby boomers move from saving *for* retirement to drawing down their assets *in* retirement, private saving will decline as private pension funds and other private financial assets shrink. Whether households would eventually restore their saving to provide for a less promising economic future is highly uncertain. While reductions in private saving might not become the principal drain on national saving,

FIGURE 3-5
Rising Deficits Under Current Policies Would Lead to A Collapse of Net National Saving
 (Net National Saving as a Percent of Net National Product)



Source: Long-Term Economic Model, See Endnote 13.

private saving behavior might still exacerbate the economic difficulties generated by ballooning federal deficits.[†]

A VICIOUS CIRCLE OF SLOWER GROWTH

By running large federal deficits and cutting national saving, America would be essentially mortgaging its economic future. As explained above, lower national saving in one year would yield a smaller increase in the domestic capital stock (or greater net international indebtedness) the next. With less additional capital in the hands of workers, the growth of labor productivity would be diminished, and net income from abroad would fall or grow more slowly as well. Both these factors would reduce the

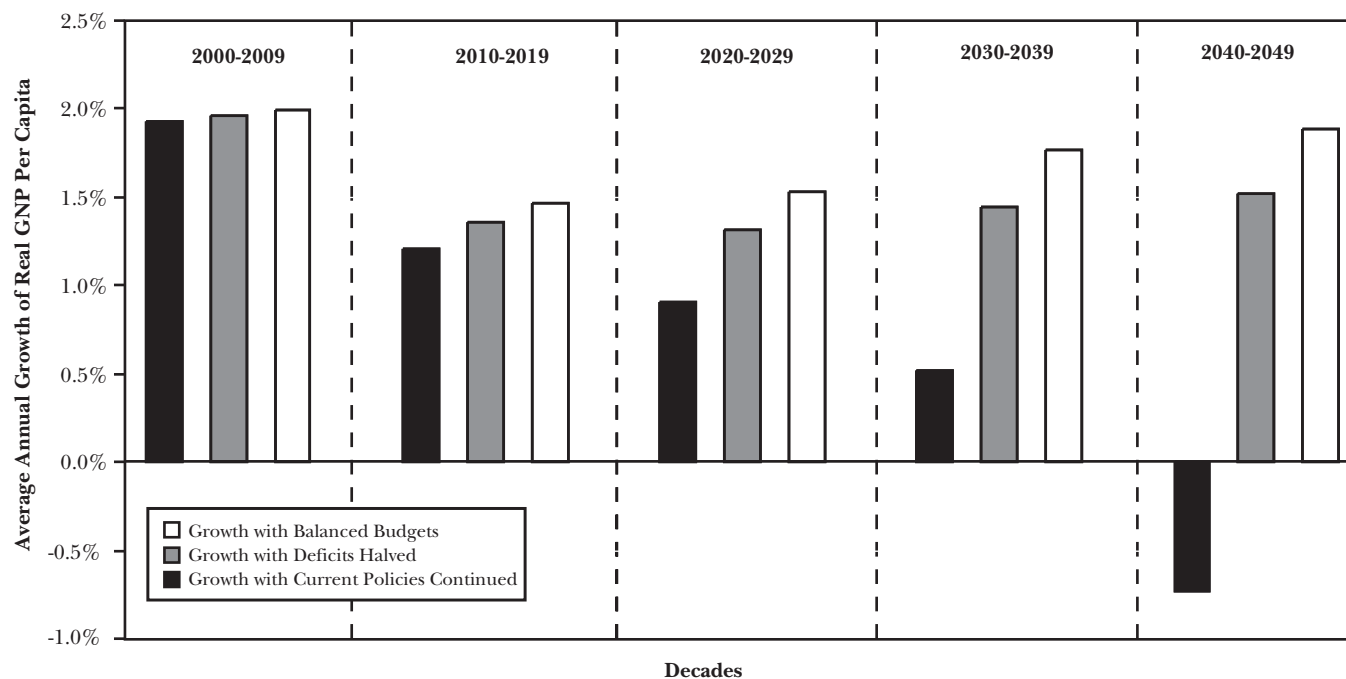
growth of national income; future Americans would be poorer so that today's Americans could live better.

To better articulate the potential implications of a decline in national saving, we employ a simple long-term model of the U.S. economy.¹³ Simulations even with large econometric models are precarious, so the results of this relatively simple model should be seen as illustrative. However, the model illustrates dramatically how the budgetary costs of population aging, a decline in national saving, and reduced investment would tend to damage the economy.

In the model, we focus on the likely erosion of federal government saving, since this represents the principal economic danger during the demographic transition. We assume (perhaps optimistically) that the personal saving rate remains unchanged. To illustrate the implications of current federal policy, the model is applied to three long-term scenarios – a baseline scenario in which the federal budget continues on its present track, with Social Security and health care expenditures growing as projected but revenues held constant at about the current share of GDP; a scenario in which the

[†] In theory, completely “rational” and far-seeing households might quickly reduce their consumption to maintain their saving and thereby provide for a future economic disappointment. It seems to us more likely that there would be considerable resistance to such changes in living standards, so that households would only slowly adjust their expectations and consumption. This slower adjustment would reduce the personal saving rate.

FIGURE 3-6
Deficits Would Slow Economic Growth
 (Average Annual Growth of Real GNP per Capita)



Source: Long-Term Economic Model, See Endnote 13.

government cuts projected deficits by half from 2008 onwards; and a third scenario in which the federal government permanently balances its books by 2008.[‡] The baseline trajectory of budget expenditures is based on projections by the Social Security and Medicare Trustees and CBO. However, the model incorporates the more realistic assumptions about the trend of budget deficits in 2004-2013 described in Chapter 2.

The model tells an ominous story about the dangers of continued and growing government consumption and borrowing. Staying on our present track, spending for Social Security, Medicare, and Medicaid skyrockets, while revenues fail to keep pace. The federal government deficit would balloon from approximately 1.6 percent of GNP in fiscal year 2002 to 10 percent

of GNP in 2030 and 29 percent in 2050.[§] Plummeting federal saving would push net national saving from its already low level of 2.5 percent of net national product in fiscal year 2002 to zero just after 2020, after which we would begin to “consume” our capital stock, with new investment insufficient to replace depreciated capital. [See Figure 3-5] As the reduction in national saving and investment proceeded, the growth of productivity and income would suffer. Whereas real GNP per capita is expected to grow at about 2 percent annually during the next several years, by the 2020's, per capita income growth would have fallen by more than half, and by 2040 the model projects growth rates of very nearly zero. This is not to argue that such a dis-

[‡] In the latter two scenarios, the adjustment to the lower deficit path is phased in from fiscal year 2004 to fiscal year 2008. Revenues and expenditures are adjusted incrementally in each year, so that deficits are halved, in one case, and eliminated, in the other, by 2008.

[§] We use Gross National Product (GNP), as opposed to Gross Domestic Product (GDP) to measure the size of the economy and, by proxy, the standard of living. Gross national product is the measure of all income received by Americans, from domestic or foreign sources, and is therefore the appropriate measure when considering long-term per capita income growth. Gross domestic product measures total income generated within the country – whether paid to Americans or foreigners.

mal economic future must come to pass, but that the costs of inaction are severe.

To better illustrate the role of deficits in slowing economic growth, we compare these results with simulations from the two other scenarios in which the federal government substantially reduces its budget deficits. The results are shown in Figure 3-6. Under these scenarios, national saving is higher and long-term economic growth is more robust. Although growth slows initially even with balanced budgets from 2008 onwards, due to America's changing demographics, it remains considerably stronger than under the scenario of large government borrowing. For example, by the 2030's, the balanced budget scenario yields an average annual real GNP per capita growth rate of 1.8 percent – two and a half times that expected if federal deficits remain

uncontrolled. In the balanced budget scenario, these relatively robust growth rates would then be maintained over the next several decades.

These simulations give a clear warning. If we do not change our current fiscal course, we are inviting a low-growth economy. Such a steep and protracted rise in federal deficits and fall in economic growth rates would be unprecedented. Perhaps for the first time in this country's history, most Americans could no longer expect their children and grandchildren to have higher living standards than their own. To avoid this bleak prospect, we need to act. Chapter 4 details CED's recommendations for changing the course of fiscal policy to increase national saving today, protect national saving for the future, and safeguard the living standards of generations to come.

Endnotes

1. Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds (Trustees of the Social Security Trust Fund), *2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (2002 Trustees' Report)* (Washington, D.C.: Social Security Administration, 2002), Table V.A2, Intermediate Cost Assumptions, available at <http://www.ssa.gov/OACT/TR/TR02/lr5A2-2.html>, accessed November 15, 2002; David M. Cutler, James M. Poterba, Louise M. Sheiner, and Lawrence H. Summers, "An Aging Society: Opportunity or Challenge," *Brookings Papers on Economic Activity*, no. 1 (1990), p. 1; and U.S. Census Bureau, *Florida*, available at <http://quickfacts.census.gov/qfd/states/12000.html>, accessed November 20, 2002.
2. Trustees of the Social Security Trust Fund, *2002 Trustees' Report*, p. 14.
3. Trustees of the Social Security Trust Fund, *2002 Trustees' Report*, Table V.A1, Historical Period, available at <http://www.ssa.gov/OACT/TR/TR02/lr5A1-h.html>; Felicitie Bell, *Social Security Administration Area Population Projections: 1997* (Washington, D.C.: Social Security Administration, 1997), available at <http://www.ssa.gov/OACT/NOTES/AS112/tab3.html>, accessed November 20, 2002.
4. Trustees of the Social Security Trust Fund, *2002 Trustees' Report*, Table V.A3, Historical Period, available at <http://www.ssa.gov/OACT/TR/TR02/lr5A3-h.html>, accessed November 20, 2002.
5. Trustees of the Social Security Trust Fund, *2002 Trustees' Report*, Table V.A3, Intermediate Cost Assumptions, available at <http://www.ssa.gov/OACT/TR/TR02/lr5A3-h.html>, accessed November 20, 2002.
6. Trustees of the Social Security Trust Fund, *2002 Trustees' Report*, Table V.A2, Intermediate Cost Assumptions.
7. Committee for Economic Development (CED), *Reforming Immigration: Helping Meet America's Need for a Skilled Workforce* (Washington, D.C.: CED, 2001), p. 7.
8. Trustees of the Social Security Trust Fund, *2002 Trustees' Report*, Table V.A2, Intermediate Cost Assumptions.
9. Trustees of the Social Security Trust Fund, *2002 Trustees' Report*, Table V.A2, Intermediate Cost Assumptions; Authors' Calculations.
10. Douglas W. Elmendorf and Louise M. Sheiner, "Should America Save for Its Old Age? Fiscal Policy, Population Aging, and National Saving," *Journal of Economic Perspectives*, no. 3, 14 (Summer 2000), p. 64.
11. Elmendorf and Sheiner, "Should America Save for Its Old Age? Fiscal Policy, Population Aging, and National Saving," p. 71.
12. A fiscal gap of 4.9 percent of GDP results from combining the 2004-2013 projections of Figure 2-4 with the baseline assumptions of the long-term growth model described below and using the model's calculations. This is virtually identical to the 4.8 percent found in a recent study using similar assumptions. See Alan J. Auerbach, William G. Gale, Peter R. Orszag, and Samara R. Potter, "Budget Blues: The Fiscal Outlook and Options for Reform" (Washington, D.C.: Brookings Institution, forthcoming).
13. The basic structure of the model is that used by the General Accounting Office in their long-term simulations. See General Accounting Office, *National Saving: Answers to Key Questions*, Appendix II, The Economic Model and Key Assumptions, June, 2001 GAO-01-591SP. The assumptions, simulations, and results reported here are those of CED and not attributable to GAO.

Chapter 4

Budget Policies for Growth

The analysis and projections presented above show that our current budget policies, if sustained, would significantly reduce long-term economic growth and therefore the capacity of our society to reach its widely shared private and public goals. Some of the underlying forces driving us towards a low-saving and low-growth future are inescapable; demography may not be destiny, but it will relentlessly weigh upon the economic outcomes possible and the policy options available. Other developments, such as the rapid and broad expansion in our international responsibilities and commitments since September 11, 2001, while perhaps more subject to deliberate choice, also seem likely to introduce heavy new economic burdens. How should we respond to these demands upon our resources?

While projections based on reasonable assumptions about current budget policy show future deficits rising to unprecedented peacetime shares of the economy, such an outcome is highly unlikely. The public, perhaps – but certainly the financial markets – will not sit by passively as deficits rise to five, ten, and then twenty percent of GDP and damage the economy. As noted CED economist Herb Stein once famously held, “if something cannot continue, it will stop.” Something has to give. But what? And when?

UNPALATABLE CHOICES

The options for fiscal restraint today are extremely unpalatable. The list essentially boils down to this:

1. Curtail homeland security expenditures – when Americans face an unprecedented threat from international terrorism and like-
- ly homeland security costs already appear to be substantially understated in the budget?
2. Restrict military spending – when threats in the Middle East and North Asia imply a dramatic extension of U.S. responsibilities for international security and stability through the projection of military power, pacification, and nation building?
3. Reduce future Social Security benefits – when the leading proposals for social security “reform” from both parties would effectively guarantee currently scheduled benefits not only to current retirees, but to future retirees as well?
4. Cut back on Medicare payments – when there is widespread political agreement to enact expensive prescription drug coverage, an increasing lack of insurance coverage for those 60-65, and a resumption of very rapid increases in health care costs?
5. Curb Medicaid expenditures – when the number of low-income families without medical insurance continues to grow, and states not only are cutting current Medicaid expenditures, but also appear unlikely to be able to sustain the current program in the longer term?
6. Cut non-defense discretionary expenditures – when special interest spending continues unabated and most of the public investment programs that support economic growth fall into this category of expenditures?
7. Forgo additional personal tax cuts, or even raise taxes – when the political commitment to further tax reduction appears determined and long-term tax cuts are advertised as the means to accelerate short-term growth?

It is hardly surprising that the effective response to the question “*what gives?*” is usually “none of the above.” Similarly, when confronted with such unpalatable choices and their political implications, the response to the question of *when* a major course correction must be made is: “Later.” Perhaps we will grow our way out of the deficit; or the terrorist threat will abate; or peace will break out in the Middle East; or medical costs will stop rising.

CED has very different answers to both these questions.

CAN WE “GROW OUR WAY OUT” OF THE LONG TERM DEFICITS?

Those who resist the need to change our fiscal direction sometimes argue that, because our large deficits in 2002-2004 are due in significant part to the recent recession, economic growth (aided by the growth-enhancing effects of tax cuts) will raise enough revenues to solve “the deficit problem.”

Some holding this view argue that full recovery from the recent recession will take care of the deficit. The optimistic CBO projections—*without any further tax cuts*—show the budget moving back into balance by 2008, several years after the recovery has been completed. However, as Chapter 2 indicates, it appears much more likely that budget policies will leave us with significant and growing deficits at the end of this decade even after we gain the additional revenues produced by a “full employment” economy. The inevitable uncertainty surrounding the projections leaves room for either outcome.

But differences in projections for the next decade have relatively minor implications for the problem of long-term deficits. There are two reasons for this. First, the rapid acceleration of spending that will accompany an aging population begins only at the end of the decade, after which the problem becomes much worse. Second, once the economy has recovered, revenues will grow roughly in line with its productive capacity; there will be no more “revenue bonuses” from economic recovery. So the

critical question is whether tax cuts will have long-term “supply-side” effects on productive capacity that outweigh the negative effects produced by the larger deficits they entail. Economic studies of these conflicting effects indicate that, while lower marginal tax rates do increase work and saving incentives for some individuals, the positive effects of these incentives are relatively modest and in the long term will be more than offset by the growth-reducing effects of the larger deficits they create.¹

Another way to gauge the likelihood of “growing our way out of the deficit” is to ask how much faster the economy would have to grow to eliminate the long-term budget deficit. The simple long-term growth model described in Chapter 3 can be used to make such an estimate. We increased economic growth in the model by assuming more rapid increases in total factor productivity while tax revenues remained the same share of the economy (with no additional tax cuts) and program expenditures remained at their baseline levels, apart from the automatic rise in Social Security benefits that reflects higher wages. Even under such very conservative assumptions, the rate of productivity growth would have to be about 50 percent higher just to bring the budget into balance by the mid-21st century – and deficits would still be rising for about the next thirty years. We know of no reputable analysis finding that tax cuts would raise long-term productivity growth by anything close to 50 percent. And, even then, we doubt that those who believe growth to be a sufficient prescription to our fiscal problem have a fifty-year time frame in mind. Unfortunately, therefore, higher growth will not appear like manna from heaven. It will require pro-growth policies. And these will require sacrifice and some very difficult choices.

WHAT GIVES? PRINCIPLES FOR FISCAL POLICY CHOICES

We do not deny the difficulty of the choices we face, but we do insist that we must make them, however unpalatable. It is far better that we make them carefully and deliberately rather

than in the crisis atmosphere that may ensue if we leave them unattended.

We do not offer a set of detailed budget proposals in this policy statement. However, we do describe below some recommended directions for major long-term policy changes that we believe would significantly alter our fiscal course and improve prospects for the economic future. Those recommendations are grounded in five principles that we believe should inform any long-term fiscal policy program.

1. ***Any tenable budget program must address the budget deficit on every front, including both comprehensive spending reductions and alternative or additional revenues.*** The very fact that our budget policy options are so unpalatable suggests one principle for addressing the problem. Since there appear to be no large “low-priority” targets that could bear most of the weight of retrenchment, restraint must be imposed on a wide front, involving all of the broad areas listed above. (At a programmatic level, of course, discriminating choices must be made, as noted below.) A broad imposition of restraint will also contribute to the sense of “shared sacrifice” that we believe will be essential to achieve a responsible long term program.

2. ***Do no harm.*** The first step in climbing out of a hole is to stop digging. Given the great contingent dangers as well as the enormous predictable costs that lie ahead, our current fiscal course of “business as usual” is indefensible. Since the 2001 tax cut was enacted, the trajectory of federal expenditures over this decade, *excluding* proposed additions to the defense and homeland security budgets and the possible costs of war, has risen by about 2.2 percent of GDP (\$340 billion in 2010). The longer term trajectory of spending and revenues entails ever-expanding entitlement spending and deficits that imply a massive “fiscal gap” (or actuarial shortfall) of about 5 percent of GDP as noted in Chapter 3.² We must begin to adapt today’s “short-term” fiscal decisions to these realities. Recent and pending proposals by the Administration and decisions by the Congress should be reexamined in this longer-term context. We believe it is simply not responsible (for

example) to adopt agriculture subsidy and relief legislation that is largely divorced from need or damages incurred; to continue military systems addressed to the Cold War rather than our new national security needs; to add prescription drug benefits to Medicare without adopting changes to improve the overall efficiency of the program; or to enact additional tax cuts, even if they have some economic merit, without taking into account our fiscal problem.

3. ***Make long-term budgetary balance and economic growth explicit policy goals.*** As budget pressures grow, there is a grave danger that other goals will preempt fiscal balance and growth. National and homeland security costs have increased dramatically; retiree pension benefits and health care costs are rising inexorably; and tax reductions have become the dominant feature of budget policy. Little attention is now given to future deficits. Indeed, the argument that “deficits don’t matter” has now resurfaced, after a twenty-year period in which Congress worked on a bipartisan basis to reduce them.

Without long-term fiscal policy goals, U.S. budget policy is adrift without an anchor. Without an anchor, our budget policy will be driven by the political winds. And the political system will reward budget decisions that produce quick benefits and defer costs. It is essential that a recognition of the very large long-term costs that loom ahead inform our decision making.

4. ***Give pro-growth policies higher priority.*** We must avoid budget cuts that reduce public investments in favor of today’s consumption. As the budget deficit grows, there will be great pressure to reduce expenditures that are “controllable” and “deferrable,” given the difficulty of reducing “uncontrollable” entitlement programs with very large and politically powerful constituencies. As a result, a disproportionate burden of fiscal restraint is likely to fall on annually appropriated programs, including education and training programs that build human capital, research and development programs that advance knowledge, and infrastructure investments that support the private sector. A pro-growth fiscal policy requires different priorities.

5. *Distribute the costs of pro-growth policies equitably.* A fiscal program for long-term growth inevitably requires some reduction in current private or public consumption to provide the resources for investment. The mechanism for this reallocation is fiscal restraint – lower budget expenditures and/or less tax reduction. Who should bear these costs? We believe, as a general matter of “horizontal equity,” that programs with widely shared benefits are preferable to those with benefits tailored narrowly to few recipients; and, as a matter of “vertical equity,” that the costs of fiscal restraint should not be placed disproportionately on low-income families with little political voice. As former OMB Director David Stockman said, in a different era but similar context, we should resist weak claims, not weak claimants.³

COORDINATING LONG- AND SHORT-TERM POLICIES: DO WE NEED MORE FISCAL STIMULUS?

It is essential to distinguish between short-term and long-term considerations in considering the timing of policy change.

We believe that we must begin immediately, in the 2004 budget, to deal with the explosion of the *long-term* deficit. We hold this view for three principal reasons: First, increasing future productive capacity by adding annual increments to our stocks of physical, human, and knowledge capital takes time; the laws of compound interest are generous in the longer term, but the fruits of investment do not ripen overnight. Second, the longer we wait to make budget corrections, the larger, more economically and socially disruptive, and more politically difficult, those corrections will be. For instance, the changes in Social Security benefits or taxes required to restore 75-year actuarial balance would have to be about 25 percent larger if made in 2014 rather than in 2004.⁴ Finally, we candidly recognize that, in practice, adopting policies to change our long-term budget course will take time. (It took approximately 15 painful years, from 1982 to 1997, to restore

budget balance after our last experience with large and potentially exploding deficits.) Because a shift towards budget restraint will be necessarily lengthy, we would be well advised to begin now.

However, this does not mean that a more restrictive short-term fiscal policy should be adopted for 2003 or 2004. We recognize that the U.S. economy is undergoing a slow and relatively “jobless” recovery, in which continuing large productivity gains are curtailing the demand for labor, and business investment remains weak in the shadow of geopolitical uncertainty and the excess capacity created during the euphoria of the late 1990’s boom. Under these circumstances, policies to reduce total public and/or private spending this year and next would be unwise, since they risk further weakening the recovery.

How, then, should we balance these short and long-run concerns? Immediately after the terrorist attacks in September 2001, as the business recession was gathering force, CED recommended a program of short-term and *temporary* fiscal stimulus.⁵ That, however, was sixteen months ago. A modest stimulus program was subsequently adopted, and economic activity has now been increasing gradually for about one year. **CED believes that a more expansive fiscal policy at present would be unnecessary and imprudent.** We hold this view for three reasons:

1. Unless a war produces a significant shock to the economy, the recovery should accelerate as uncertainty declines, excess capacity falls, and the Federal Reserve maintains the monetary easing initiated in 2001. Recent fiscal policy has been very expansive. From 2001 to 2002, the “high employment” budget became more stimulative by \$233 billion (2.3 percent of GDP);* the economy has received total stimulus as large or larger than the losses in output it has experienced during the downturn.⁶ In addition “supplementary” spending on military and homeland security, war, and reconstruction is likely to

* The change in the “high employment” (or “standardized-budget”) surplus or deficit is a widely accepted measure of the fiscal stimulus produced by changes in budget policies.

raise 2003-2004 federal expenditures well above currently budgeted levels.

2. Even if additional immediate and temporary economic stimulus were needed, the U.S. legislative process virtually guarantees that any fiscal program will be delayed in its enactment and implementation. Significant economic effects from policy changes considered in the next few months are unlikely to appear before 2004, when the economy is likely to be stronger than today. Such counterproductive timing lags have been typical of U.S. fiscal policy.

3. Most important, the current policy environment suggests that any significant stimulus program is likely to damage our long-term fiscal position and undermine our growth objectives. **CED strongly opposes any short-term stimulus program that is not combined with a plan to restore longer-term budget balance.** We are specifically concerned that the Jobs and Growth Package proposed by the Administration, which would raise the cumulative 2004-2013 deficit by about \$920 billion (including interest) and raise the annual deficit ten years from now by about \$100 billion, does not meet this test.⁷

As noted below, our objection to these proposals is not directed at their merits as tax policy, but at their destructive long-term fiscal impact. There is a coherent argument, for example, for eliminating the double-taxation of dividends at the corporate level, and expert observers from a variety of political perspectives have pressed for tax simplification. Our view, however, is that the revenue losses generated by such policies must be offset by other revenue increases that would allow us to improve the efficiency of the tax system without worsening long-term fiscal problems.

RECOMMENDED DIRECTIONS FOR POLICY

Provide a Framework for Long-Term Budgetary Decision Making

As noted in Chapter 2, the Congressional budget process effectively self-destructed after

fiscal year 1998. In some succeeding years no budget resolution was adopted; in others, resolutions were honored more in the breach than observance; and in many instances they were rendered ineffective by unrealistic spending targets and estimates. Perhaps more important, appropriation bills have been repeatedly delayed and sometimes never completed, giving rise to “omnibus” ad hoc spending legislation that greatly impedes rational planning both by public agencies and private recipients of government funds. Such legislation also provides fertile ground for narrow, self-interested spending projects. In addition, the legislated budget control mechanisms limiting discretionary spending, entitlement expansion, and tax cuts have now expired. While these mechanisms created by the 1990 Budget Enforcement Act (BEA) were imperfect, they had bipartisan support and worked reasonably well in the early and mid-1990’s to structure and enforce budget decisions. Budget decisions are now adrift, without fiscal goals to anchor them or enforceable rules to discipline them.

CED believes it is urgent to implement a disciplined budget process that can address the long-term fiscal issues that face us. First, Congress must restore rationality to the appropriations process. Second, we should implement annual joint budget resolutions, agreed to by the Congress and the President and enacted into law, that anticipate, precede, and control all spending and tax legislation. Finally, to enforce the budget decisions of the joint resolution, we should restore caps on discretionary spending and the requirement that changes in tax and entitlement programs be “deficit-neutral.” We commend the Administration for including these proposals for budget process reform in its 2004 budget.

In addition to an effective process for decision making, rational budgeting today requires goals that are consistent with long-term growth. We recognize the importance of maintaining flexibility in fiscal policy and the ineffectiveness and futility of setting deficit targets independent of economic conditions, as attempted in the late 1980s and proposed in legislation requiring

annual balanced budgets.⁸ But it is essential that fiscal policy be “anchored in the long run by the need to preserve overall national saving and prevent explosive growth in government debt,” as recently stated by Federal Reserve Governor Edward Gramlich.⁹

We make two recommendations to encourage this long-term anchoring of fiscal policy:

(1) The President and Congress should establish a goal of balancing the budget (or producing a surplus) excluding the “off-budget” Social Security accounts over a rolling five-year horizon. The joint budget resolution should make clear how the budget policies of the resolution would promote this goal. We recognize that we cannot immediately move to a balanced budget, given the fiscal hole we are now in. While a five-year horizon is hardly long-term, this policy would have the effect of inhibiting near term fiscal policy from “digging the hole deeper” and jeopardizing long-run growth. During a brief period in the late 1990’s, before the budget process broke down, there appeared to be a bipartisan consensus for such a policy target. The exclusion of the Social Security surplus from the calculation of the deficit would, in effect, allow those resources to be channeled, through debt reduction, into national saving and investment for growth rather than used to finance current expenditures.[†] This would create a larger economy in future decades, when the Social Security bill must be paid.

(2) The joint budget resolution should also provide statistical measures of long-term fiscal balance (such as the “fiscal gap” and unfunded government liabilities) and explain how the policies of the resolution would affect those measures and future levels of taxes or public debt. Simple cash-flow calculations of revenues, expenditures, and the deficit—even taken over a period of ten years—provide notoriously inadequate and misleading measures of long-term fiscal balance and the sustainability of current

fiscal policy. As noted in Chapter 2, our current budget policies imply a “fiscal gap” over the lifetime of an American born today of about 5 percent of GDP, and unfunded federal government obligations of about \$20 trillion, which are not revealed by cash-flow accounting. In addition, this accounting leads to immediate budgetary deceptions such as enacting tax cuts that are to be “temporary” for ten years and made “permanent” later.

Ideally, our budget decisions would be constrained by the forward-looking measures we recommend, and this may be an appropriate long-term objective.¹⁰ However, even if it is politically impractical at this time to formally constrain budget decisions with such measures, the information they provide should be available to inform such decisions. That information should become politically more salient as public awareness of our long-term budget problems increases. Such information might make us think twice, for example, before adopting new tax incentives for personal saving that raise revenues slightly today but lose enormous amounts of revenue indefinitely into the future, despite our desire to increase the personal saving rate.

A budget process issue that has recently caused considerable controversy is that of “dynamic scoring” – that is, attempting to incorporate in budget estimates the full effects of tax and spending policy changes on the macroeconomy.* As a theoretical matter, of course, dynamic scoring is an appropriate procedure; no one would deny that changes in tax rates, or in the design of many public spending programs, have such effects, and they should logically be reflected in the estimates. However, as a practical matter, dynamic scoring is extremely problematic, as noted by the recent Director of the Congressional Budget Office, Dan L. Crippen, who has testified that CBO “could not...include those macroeconomic effects in a useful and credible way.”¹¹ First, such effects are extremely sensitive to future fiscal and monetary policy decisions, which cannot be predict-

[†] CED first recommended such a policy in 1947 when it proposed a budget balanced over the business cycle rather than annually, the widely accepted fiscally conservative target. The proposal here effectively adapts that proposal to current demographic conditions.

*See memorandum by CHARLES E.M. KOLB. (page 40).

ed. Second, the size—and even direction—of such effects are highly uncertain; different models and assumptions produce very different results. But the most important problem is that the application of dynamic scoring would inevitably be extremely political, since the highly controversial estimates of these “dynamic” effects would directly affect the fate of legislative proposals operating under meaningful budget constraints, such as those we recommend. We acknowledge that informational and experimental estimates by CBO and the Office of Management and Budget (OMB), based on a variety of models and assumptions, might be useful to policymakers. But we believe that dynamic scoring of CBO’s *official cost estimates* would inevitably inject politics deep into what should be an expert, non-political estimating process and greatly damage the credibility and reputation of CBO. **We therefore oppose the use of dynamic scoring for official CBO cost estimates of policy proposals.**

Reform Major Entitlement Programs

As shown in Chapter 2, the anticipated rapid growth of public pension and health care benefits for the elderly will dramatically raise federal spending and budget deficits, reducing national saving and private investment while crowding out public investments in the budget. In addition, these programs threaten to be generationally inequitable, in that they will transfer enormous resources from future workers to baby boom retirees. The demographic transition will make a substantial transfer of resources to older Americans appropriate and inevitable, but we must carefully reexamine the design of these programs to ensure they are consistent with our larger social objectives.

Social Security The Social Security system cannot meet its future legal obligations and must be reformed. Under current projections, the trust fund’s surplus of contributions over benefits will peak at the end of this decade, then begin to fall, and vanish in 2017. After this, the trust fund will be drawn down, and full scheduled benefits can only be paid until it is

exhausted in 2041.¹²

But the trust fund accounting device gives the mistaken misimpression that the crisis will not occur for many decades. As an *economic matter*, the trust fund is essentially irrelevant; the relevant measure is the difference between the public’s contributions to and withdrawals from the federal Treasury. As soon as this difference begins to *narrow*—in about 2011—the capacity of Social Security to offset deficits in the rest of the unified budget will begin to *fall*, making the overall deficit, and Treasury’s financing needs, larger.¹³ This deterioration will then simply accelerate when the trust fund actually begins to pay out more than it takes in, causing the Treasury to sell trust fund securities for cash. The effects of Social Security on the financial markets, and pressures for “crowding out” private investment, will therefore begin to increase around the end of this decade. In fact, such effects may be reflected even earlier, as such increases in the government’s financing needs are anticipated in the marketplace.

Proposals have been made to allow the Social Security to purchase private equities instead of Treasury debt, or to allow individuals to do so through private accounts, or to infuse more general revenues into the system. However, such reforms often do little to address the economic problem underlying Social Security’s financing dilemma—that we have committed ourselves to very large increases in public consumption without ensuring that we have additional resources to provide them, which can become available only through economic growth.

In *Fixing Social Security* (1997), CED proposes reforms that address the financial solvency of the current system, its generational inequities, and the need for national saving.¹⁴ We recommend a two-tier system: the current basic system, with its benefit structure modified to ensure its solvency, supplemented by a second tier of privately owned Personal Retirement Accounts that would raise returns to future retirees. The plan is described in Box 1: CED’s Proposal to Reform Social Security.

Medicare and Medicaid Increasing health

BOX 1

CED's Proposal to Reform Social Security

The CED plan for reforming Social Security would preserve the current basic system but modify its structure to restore solvency and increase national saving. In addition, it would give workers the opportunity to earn higher investment returns by establishing a "second tier" of privately owned Personal Retirement Accounts.

The changes in the basic system, to be phased-in gradually, would include:

- The initial benefit levels of upper- and middle-income workers, which currently rise with wages, would increase more slowly (but continue to rise in real terms).
- The normal retirement age (NRA), currently 65 years, would gradually increase to 70 over a period over 30 years and be indexed to life expectancy thereafter. (The NRA is currently scheduled to rise to 67 between 2003 and 2026.)
- The early retirement age, currently 62 years, would be increased to 65 over this 30 year period and subsequently similarly indexed.
- The years of covered employment included in the calculation of initial benefits would be gradually increased from 35 to 40.
- Benefits from the basic program in excess of contributions made by the worker would be taxed, with the additional revenues to be deposited in the Social Security trust funds.
- A reduction in benefits for nonworking spouses from one-half to one-third of the worker's benefit would be phased-in gradually to improve equity between working and non-working spouses.
- To make coverage universal, all new state and local government employees would be required to participate and current employees could choose to participate.

CED also proposes the creation of privately owned, personal retirement accounts (PRAs):

- Both employers and employees would be required to contribute 1.5 percent of payroll to privately owned personal retirement accounts. (The self-employed would contribute 3 percent.) These mandatory accounts would receive preferential tax treatment similar to 401(k) plans and would be subject to appropriate fiduciary regulations, including a requirement that accumulated funds be preserved for retirement. The Federal Thrift Savings Plan provides a general model for these accounts.

Source: Committee for Economic Development (CED), *Fixing Social Security*, (Washington, D.C.: CED, 1997); CED, *New Opportunities for Older Workers*, (Washington, D.C.: CED, 1999).

care expenditures by the elderly are the most dramatic example of the consumption changes expected in an aging society. But it is essential that we view this problem in its appropriate context, given that so much discussion focuses on the “burdens” involved in these expenditures. The 20th century saw enormous improvements in the quality of life, and in some cases longevity, for many elderly. It has been estimated that improvements in the health status of the population during the 20th century made as large a contribution to economic welfare as all other consumption increases combined.¹⁵ Health care is highly valued by the American public, and it is entirely appropriate that we devote an increasing proportion of national income and output to it as the society grows more affluent and new technology improves possibilities for treatment.

Notwithstanding these considerations, however, it is clear that the U.S. health care system is unsustainable and that overuse, underuse, and misuse of health care services produce both adverse medical outcomes and unnecessary costs, as we argued in *A New Vision for Health Care: A Leadership Role for Business* (2002). The health care industry, while making dramatic technological advances in diagnosis and treatment, is extremely inefficient in delivering care, and patients have little stake in costs and insufficient awareness of wide differences in provider quality.¹⁶ The U.S. now spends twice as much on health care, per capita, as other nations with equal life expectancies. *We do not claim to know the “right” proportion of our national income that should be spent on health care in the future, but we firmly believe the resources we do provide should lead to higher quality and more cost-efficient care.*

A major source of unnecessarily high costs of health care is the lack of incentives to seek higher quality and lower costs on the part of both providers and purchasers of care. Our recommendations for improving those incentives for businesses and other private purchasers of care are detailed in our earlier report and need not be repeated here. But public purchasers such as Medicare (the largest purchaser of health care) and some state governments are ineffective purchasers of care. Fee-for-service Medicare is

required by law to be a passive payer of providers’ bills and has no authority to reward providers of high quality and effectively managed care. While the Center for Medicare and Medicaid Services (CMS) has begun to make information on quality of care available to Medicare enrollees, the program lacks financial incentives to select the best performing providers.

We therefore reiterate our earlier recommendation **that Medicare be restructured along the lines of the Federal Employee Health Benefit Program (FEHBP)**. FEHBP, a highly successful plan covering nine million federal workers and their dependents, has adopted a defined contribution model that creates incentives for workers to select cost-effective health plans with affordable employee contributions. We caution, however, that even with reforms in Medicare that improve its efficiency, we are unlikely to face long-term costs that greatly reduce the long-term costs currently projected. Indeed, the Administration roughly estimates that its “Medicare Modernization,” including both prescription drug coverage and cost-reducing reforms, will add \$400 billion to Medicare costs over the next decade.

Many states have developed for their public employees, and in some cases for Medicaid enrollees, health care programs similar to FEHBP, with contribution structures that encourage choices based on appraisals of quality and cost. **CED also urges states that have not adopted such programs to do so as a means of improving both the quality of health care and the efficiency of its delivery.**

While our recommendations here focus on public expenditures for health care, we note that, as in the case of Social Security, the fundamental economic issue facing our society is not the financing of these particular programs, but the total resources used in meeting the health care needs of the entire population in the future. For this reason, CED’s recent recommendations for improving the quality and efficiency of all health care services are most relevant to our concerns here about the future well being of our society. These recommendations are detailed in Box 2.

BOX 2

CED's Vision for Health Care

CED's policy statement, *A New Vision for Health Care: A Leadership Role for Business* (2002) proposed policies through which private employers and the government, as the principal purchasers of health care, could improve its efficiency and quality. The plan does not address every aspect of America's burgeoning health care crisis. Nevertheless, the adoption of certain of its recommendations would help slow the unsustainable growth of health care costs that is a central element in our long-term budget problem.

Private employers can change their purchasing practices in ways that would enhance cost discipline and quality by:

- Demanding transparent quality information and adherence to best medical practices; using comparative performance information to select plans and providers; and incorporating accountability for cost and quality into contract specifications;
- Offering wide, responsible health plan choices to employees in exchange for their greater financial responsibility;
- Working actively with physicians and hospitals to improve quality, building on the strengths of managed care; and
- Working with public purchasers and organized labor to strengthen the drive for reform.

The federal government, as purchaser, lawmaker, and regulator of health care can address the problems of high cost and uneven quality by:

- Restructuring Medicare on the model of the Federal Employee Health Benefit Program;
- Capping the currently open-ended federal tax exclusion of employer contributions to promote cost discipline and equity; this could also provide some funding for policies to expand access;
- Enacting responsible patients' rights legislation that protects patients against unwarranted delays or denials of care, without prohibiting payments mechanisms that reward appropriate and effective standards of care or exposing businesses to unlimited litigation costs.
- Addressing the most pressing quality problems – lack of patient safety and widespread delivery of inappropriate services – by expanding research, serving as a clearinghouse for information on quality, and helping to establish national standards of care;
- Establishing oversight to promote competition in health insurance markets; and
- Strengthening initiatives to reduce fraud and abuse in Medicare and Medicaid.

Source: Committee for Economic Development (CED), *A New Vision for Health Care: A Leadership Role for Business*, (Washington, D.C.: CED, 2002).

National and Homeland Security Expenditures

The terrorist attacks of September 2001 have inevitably raised both federal and state and local government expenditures on public health and safety, and the expanded U.S. international role that has emerged since then has produced a sharp increase in current and planned military expenditures. As we argued shortly after the attacks, while a significant reallocation of public resources is undoubtedly necessary to deal with these new responsibilities, “we must not let these security concerns eclipse the need for sound economic policies, both domestic and international. In the long term, the health of our economy will largely determine the well-being of our society, including our capacity to provide safety and security.”¹⁷

In the current environment, there is a temptation to assume that budget constraints are no longer operative where security is concerned and that we must “spend whatever it takes.” However, quite the opposite is true – reconciling large, immediate public needs with other public goals, and with private consumption and investment demands, will require more stringent budget discipline, not less. Our policies must distinguish carefully between what we genuinely need for an adequate defense and the wish-lists of the military and its suppliers. Adequacy must be evaluated in a world where our 2003 defense budget is larger than those of the next 17 nations combined, and the 2001-2002 *increase* in defense spending was larger than Japan’s total 2002 defense budget, the world’s fourth largest.¹⁸

Early in 2001, the Administration discussed restructuring the defense budget by eliminating or reducing programs and activities that reflected outdated Cold War defense requirements. It suggested, therefore, skipping a generation of expensive weapons systems.¹⁹ However, there is little evidence of such restructuring in the current defense budget, which appears to have “essentially reaffirmed the Clinton Administration’s weapons modernization agenda and force structure” at higher expenditure

levels, raising the long-term defense budget by about \$100 billion per year.²⁰ The high costs and inefficiencies of the ongoing operations and maintenance activities of the military also give us concern as business leaders. The problems go well beyond the expensive continuing operation of unnecessary military bases driven by Congressional politics. The Tail-to-Tooth Commission, a study group of the non-partisan Business Executives for National Security (BENS), recently reported on its review of major studies of military expenditures. The Commission found widespread and costly inefficiencies in acquisition and accounting functions as well as in “non-military” activities such as the provision of housing, and made numerous recommendations for improving efficiency. Specifically, the Commission noted that twenty years ago, two-thirds of the defense budget was devoted to military combat capability (“tooth”) and one-third to overhead and indirect support expenditures (“tail”); today, the proportions are reversed.

We claim no special expertise on national security needs, but given the fiscal outlook we believe that the claims of respected defense analysts that we could secure a more effective defense capability for \$50 billion less than the \$500 billion per year now projected for the end of the decade deserve serious examination.²¹ **But, whatever the level of spending, the defense budget must be cost-effective and focused sharply on our new national security situation. We urge the Administration and the Congress to rapidly establish national defense priorities and program reforms to accomplish this.**

With respect to homeland security, it is evident that spending should and will rise substantially over time as we develop greater capability to protect against and respond to terrorist attacks. Here again, however, it is essential that we prioritize, even though it is politically very difficult to do so. We cannot protect against all eventualities. Some attacks are more likely than others, some are potentially far more damaging than others, and we must choose. In making these choices, we should also remember that the benefits of stronger homeland security

often involve higher costs to the economy as well as to the budget.

Decision making for homeland security may be especially problematic, since it will be principally the responsibility of the new Department of Homeland Security, which is attempting to combine many previous federal departments and agencies, with very different missions, into a single effective organization. (The new Department will handle about two-thirds of total homeland security spending.) It will be very difficult, at least initially, for such an organization to set priorities that appropriately reflect the overall security situation rather than the various missions of the former agencies. This will create strong pressures to increase the budget to cover more contingencies. An additional budgetary problem will arise because of the difficulties in preventing duplication of functions and personnel, in spite of the additional managerial flexibility provided for the new Department.

For all these reasons, we believe that homeland security expenditures will require special attention and scrutiny in the next few years, and we urge the Administration and Congress to provide this.

Finally, should another terrorist attack be made in the United States, it is likely that, once again, those responding to it will not be primarily federally-trained experts or the armed services, but local police, fire, and other personnel.²² These community forces are the front line in our national battle against terror, and the federal government must ensure that they have the resources needed to do the job.

Non-Security Discretionary Spending

Given the political difficulties in reducing expenditures on “permanently” funded entitlement programs in comparison with programs funded with annual appropriations, it is not surprising that the latter have been the favored targets for controlling federal expenditures. The last quarter-century has seen an inexorable “crowding out” of discretionary spending by entitlement programs, which have expanded from about 51 percent of total non-interest fed-

eral expenditures in the late 1970s to 62 percent in 2002, while discretionary spending has fallen commensurately from about 49 percent to 38 percent. Most of this decline, however, has occurred in defense discretionary spending, which has experienced a decades-long decline relative to the total budget and the size of the economy. Since the 1960s, defense spending has fallen from about 8.5 to 3.5 percent of GDP. By comparison, non-defense discretionary spending in relation to the budget and the economy is roughly the same as it was 40 years ago. Defense spending obviously cannot continue to fall at this rate relative to GDP in the future, so either the growth of non-defense discretionary spending relative to GDP must fall or that of total discretionary spending must rise.

Clearly there are many low-priority domestic discretionary programs, and reductions in them have been entirely appropriate. (Indeed, it is unfortunate that so few have actually been eliminated.) We hold no brief for protecting these programs in general, and especially the politically “ear-marked” spending that rewards narrow interests. **We can and should bring the rate of growth of non-security discretionary spending below its historical level and far below the 9 percent growth of the past three years.**

Although the Administration sought to restrain such growth, the enacted omnibus 2003 appropriations bill has raised discretionary spending about \$12 billion above the level earlier agreed to by the President and the Congressional majority leadership. The untimely and chaotic process of enacting 2003 appropriations has dramatically demonstrated the need for the strong process reforms we propose, and the history of this ad hoc legislation increases our concern that insufficient discrimination will be made between effective and ineffective programs. As budgetary pressures grow in the future, it will be more difficult to sustain investment programs that support economic growth. Two areas of investment cause us particular concern—public education and research and development.

CED has long advocated both reforms and increased investments in public education, espe-

cially in improving poorly performing schools in many low-income communities, and in moving towards universal pre-school.²³ We must improve the achievement of children attending low-performing schools both to support economic growth and to promote equal opportunity. We have argued that improvements in learning will require more attention to, and accountability for, educational outcomes, and for that reason have supported federal legislation and state initiatives designed to do this. But we have also noted the serious difficulties likely to arise in implementing such accountability measures.²⁴ We are now at a critical juncture in these reform efforts. The states have been given a task of raising the achievement test scores of all students, which would be enormously difficult in the best of circumstances. In the circumstances they actually face, many states and communities are ill-prepared to meet these goals, and the fiscal crises facing most states will severely limit the resources they can draw upon to do so. **We believe that education reform is too important to be allowed to fail; the federal government, which has mandated a national effort, is obligated to assist the states in making it work. We urge the Administration and Congress to provide the funding needed to do so.**

CED found in an earlier study that basic research in science and engineering has made a major contribution to the growth of the U.S. economy. Economic returns on investments in basic research are very high. In addition, the returns to the nation from basic research investments are substantially higher than the returns to private firms, since advances in fundamental knowledge tend to be widely dispersed and exploited in innovations that deliver substantial economic benefits over a lengthy period.²⁵

Publicly-funded basic research is critical to private sector innovation. Although private industry conducts basic research, these efforts are primarily to “fill-in-the-gaps” within broader programs of applied research aimed at new product development. Industry depends on the intellectual foundations provided by basic researchers in the nonprofit and public sectors for innovative

products and services; 73 percent of research publications cited by industrial patents have been found to be derived from government-funded research.²⁶

Because federal support is essential for a thriving basic research enterprise, we urge the Administration and Congress to make basic research a high priority in the federal budget. Funding should be provided across a broad set of research fields, without undue concentration in medical research.

We have also found that deficiencies in science teaching in primary and secondary education threaten our future supply of outstanding young researchers. We will provide a series of recommendations in a forthcoming report to address this problem.²⁷

As noted above, expenditures on discretionary non-defense spending have grown at about the same rate as the economy for many years. We are certainly no admirers of formulaic budgeting, and support the reduction and elimination of low-priority programs whenever possible. But our budgetary history suggests there are significant social and political limits to such reductions. In light of the need to continue high-priority programs, and in particular public investments, we believe it would be imprudent to assume that domestic discretionary expenditures in the aggregate will grow continuously more slowly than the economy in the future.

Taxes*

CED has for many years, and in many policy statements, taken the position that the federal government should balance its budget, averaged over years of economic strength and weakness.²⁸ As explained in Chapter 1, we strongly believe that deficits *do* matter to our long term growth and prosperity. We do not believe that we should deliberately run budget deficits as a means to discipline spending. This has not worked in the past and is a counsel of despair. Deliberately

*See memoranda by JAMES Q. RIORDAN, JOSH S. WESTON, and CHARLES E.M. KOLB (page 41).

hamstringing future Congressional decision making cannot be good public policy; Congress should, and can, budget effectively with the decision making framework described above.

We believe that additional reductions in federal revenues would be inconsistent with the goal of long-term budgetary balance. The analysis in Chapters 2 and 3 shows that realistic projections of federal expenditures and revenues, especially when combined with further tax reductions, produce deficits that grow significantly during the coming decade and explode thereafter.

Of course, if extremely large spending reductions could be made—in the face of the demographic, social, and political facts and our escalating security requirements—we could afford to reduce revenues further, at least in the medium term. **However, after reviewing the size of our long-term fiscal imbalance and the broad possibilities for spending reductions in Social Security, Medicare, national defense, homeland security, and other domestic programs, CED believes it extremely unlikely that the long-term budget problem can be solved without additional revenues. We therefore urge the Administration and Congress to forego at this**

time any additional tax reductions (including the permanent extension of EGTRRA) that would further reduce long-term revenues. Moreover, we should use this opportunity to begin to explore alternative or additional long-term sources of revenue and taxation systems that support our long-term growth objectives.

CONCLUSION

America now stands at a fiscal crossroad. The federal government's fiscal position looking out over the next decade has deteriorated to an alarming degree. At the same time, we draw closer each day to the dramatic demographic changes that will sharply increase those fiscal difficulties, with adverse economic consequences, if we remain on our current course. It is urgent that we begin to act now to adopt a program of policy changes, across a broad front, that address our inadequate process for making budget decisions and the untenable trends in federal entitlement programs, discretionary spending, and revenues that threaten the economic future of the nation.

Endnotes

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Memoranda of Comment, Reservation, or Dissent

Page 1, JAMES Q. RIORDAN, with which THOMAS J. BUCKHOLTZ has asked to be associated.

The Policy Statement indicates that there is a real danger that we will face significant deficits in the coming years and reaffirms that deficits matter. The Policy Statement goes on to state: We need to control the growth of federal expenditures. Our Congressional control process has broken down in recent years, and it needs to be reestablished. We need to commit to raise the revenues required to balance the budget over the economic cycle. We need to adopt economic and tax policies that will facilitate economic growth. These views are vintage CED and need restating.

The Policy Statement unfortunately loses its focus by attempting to be timely and relevant in the context of the current partisan forecasting debate. I am concerned that the Report will not have the desired long-term policy impact because it will be viewed as just another political document.

Page 1, THOMAS J. BUCKHOLTZ.

The Recommendations (pages 2 and 3) note themes (such as growth, deficits, and fiscal prudence) and programs (such as Social Security and education reform).

The intent to make progress regarding each item is laudable, but may not provide an adequate framework for capturing the broader opportunities and addressing the broader challenges for which each item provides examples.

A broader approach can focus first on desired future outcomes, with categories being ones such as national security (international and homeland), quality of life (e.g., safety, freedom, education, healthcare, and retirement), the economy (e.g., international and domestic commerce), and infrastructure (e.g., environment, energy, information technology, and transportation). People can formulate, debate, and advance principles, visions, or goals for the entire collection of categories, individual categories, and parts of categories. From there, the country can formulate and implement programs or program modifications

that reasonably balance estimated future needs, estimated future resources (including government revenues), and past commitments. Programs can become simpler, with leadership being more clearly rooted in appropriate entities in the private sector or one or more levels of government.

For example, absent such an approach the Social Security retirement program remains a past and continuing commitment for which debate potentially overly centers not on needs of people or purposes of the program but instead on maintaining or altering formulas that are rooted in decades-old assumptions. Which such an approach, American society has a better basis for providing services – perhaps focused on quality of life – aimed at meeting individuals’ and society’s future needs and at honoring past and future contributions.

An outcome of such an effort can be clearer-purposed, simpler governance. The steps to achieving such can catalyze beneficial public involvement in setting policies.

Page 30, CHARLES E.M. KOLB.

As to the practicality of dynamic scoring, I am more optimistic that such an approach can be tried without injecting undue “political” influence on the integrity of the Congressional Budget Office’s official cost estimates. We know that the traditional “static” scoring process does not capture the complete macroeconomic effects, or incentive effects, of changes in tax and spending policies. An effort to identify such effects through a dynamic analysis that is fully transparent in terms of its underlying assumptions is worth implementing. A dynamic “analysis” – to be distinguished from dynamic “scoring” which produces a single number as the projected cost of a particular bill – would present a range of estimates that would, on balance, be more informative to the Congress than a single number based on “static” scoring.

Page 37, JAMES Q. RIORDAN, with which PETER A. BENOLIEL has asked to be associated.

The weakest part of the Policy Statement is its discussion of tax policy. CED has made clear that our

current social security and health care systems are not sustainable and must be reformed. We should be equally clear that our current tax system is not sustainable and must be reformed.

At tax system must raise revenues needed to balance the budget over the economic cycle and must do it in ways that facilitate economic growth. At a minimum, this means that the tax system must be less complicated and less biased against saving. Furthermore, as stated by Federal Reserve Board Chairman Alan Greenspan, it will be self-defeating if it attempts to commandeer too much of the national economy. Admittedly, these objectives are easier to state than to achieve. Unfortunately, they will not be achieved by the proposals of the Republican Administration; the Democratic congressional leadership; or the tax proposals in this CED report.

We need a thoughtful, comprehensive approach to reforming the tax system for the long term. I hope that CED will soon take the lead in that effort as it has attempted to do in the case of the Social Security and health care systems.

Page 37, JOSH S. WESTON, with which PETER A. BENOLIEL, T.J. DERMOT DUNPHY, and ROCCO C. SICILIANO have asked to be associated.

The prospect of huge, ongoing deficits should lead us to reconsider previous proposals for an increased gas (motor fuel) tax. The case is compelling.

Federal Deficits – Each penny per gallon tax is worth one billion dollars in extra annual revenue. (The gas tax in most European countries is almost two dollars per gallon higher than ours.)

Dependence on Middle East Oil – The U.S. depends greatly upon the Middle East. This creates a huge unfavorable national security cost plus constraints on foreign policy, while holding our security and economy hostage to foreign disruptions. (60 percent of our oil comes from abroad.)

Unfavorable Trade Balance – We had a \$435 billion trade deficit in 2002, much due to oil imports. It is draining our capital. A gas tax would indirectly discourage oil imports.

The Need for Cleaner Air – Reduced gas consumption can improve air quality and climate

concerns. It would also help narrow our “Kyoto gap” with other nations.

The Prospective Graying of America – Our aging population will place huge demands on the Social Security and Medicare systems. They cannot be handled without more federal revenues and/or reduced benefits.

Legislation to increase our present pump tax by 10 cents annually for each of the next twenty years would induce changes in miles per gallon and auto usage, while providing incremental federal revenue. This price change is much smaller than usual past market fluctuations, which have not had noticeable economic effects. Consumers already often pay more for a gallon of bottled water than for gas.

A gas tax is simple to administer and difficult to evade. It would give automobile makers greater confidence to invest in energy-saving technologies, whether through vehicle weight, engine efficiency, fuel choice, or other means. And, it would promote mass transit.

Between 1975 and 1988, the average fuel economy of the U.S. vehicle fleet rose from 15 miles per gallon to 26; since then, it has not improved. It is time to take action to restore the earlier, helpful trend. In time, the benefits of better energy efficiency and environmental performance would offset the burden of the tax.

Page 37, CHARLES E.M. KOLB.

The Policy Statement urges the Congress and the Administration to begin to explore “alternative or additional long-term sources of revenue and taxation systems that support our long-term growth objectives.” To the extent that this admonition suggests that we should contemplate raising taxes at this time, I express my reservations. We should avoid policies and exacerbate our long-term structural deficit while at the same time seek ways to reduce spending. One way to achieve this goal is for the Congress to enact the type of budget-process constraints that will ensure a more disciplined approach to spending. CED endorses such reforms with which I concur. However, given the current state of the U.S. economy, now is not the time for a discussion of tax increases.

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